REVENUE INCREASE OPTIONS

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

JULY 7, 8, 9, AND 15, 1987

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Art Institute of Chicago, Quinn E. Delaney, letter 2015
(Similar letters were also received from the following Trustees of the Art Institute of Chicago: Warren L. Batts, Premark International; H. Laurence Fuller, Amoco Corporation; Charles A. Meyer, Chicago, Ill. [also for the Children's Memorial Medical Center, Cradle Society of Evanston, and Lake Forest College]; Edward Byron Smith, Northern Trust Company; and Elizabeth B. Tieken, Chicago, Ill. [also for the Field Museum]).
(Similar letters were also received on behalf of the Chicago Academy of Sciences: Allan E. Bulley, Jr., Bulley & Andrews; John H. Cynkar, Coopers & Lybrand; and Christopher Dunn, Chicago, Ill.).
(Similar letters were also received on behalf of the John G. Shedd Aquarium of Chicago: William J. Cullerton, The Cullerton Company; Benjamin F. Lenhardt, Jr., First National Bank of Chicago; Robert D. Krebs, Chicago, Ill.; J. Donald Higgis, Harris Bank; John Shedd Schweppe, M.D., Chicago, Ill.; and D. Gideon Searle, The Serafin Group).
(Similar letters were also received on behalf of the Lyric Opera of Chicago: Edward Byron Smith, Northern Trust Company; and Louise Smith, Northern Trust Company).
Association of Governing Boards of Universities & Colleges, Robert L. Gale, letter 2017
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REVENUE INCREASE OPTIONS

TUESDAY, JULY 7, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room 1100 Longworth House Office Building, Hon. J.J. Pickle presiding.

[The press releases announcing the hearings follow:]

FOR IMMEDIATE RELEASE
THURSDAY, JUNE 25, 1987

PRESS RELEASE #13
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARINGS ON REVENUE INCREASE OPTIONS

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold three days of public hearings from Tuesday, July 7 through Thursday, July 9, 1987, on options to raise revenues in order to meet the reconciliation instructions to the Committee on Ways and Means contained in H. Con. Res. 93, the Concurrent Resolution on the Budget for Fiscal Year 1988. Specifically, section 4(s)(2) of H. Con. Res. 93 requires the Committee on Ways and Means to report legislation which raises revenues by $19.3 billion in Fiscal Year 1988, $22.0 billion in Fiscal Year 1989, and $23.0 billion in Fiscal Year 1990, a total of $64.3 billion over the next three fiscal years. Furthermore, H. Con. Res. 93 requires the Committee on Ways and Means to report its reconciliation recommendations (both revenue and spending reduction provisions) on, or before, July 28, 1987. The hearings will begin at 10:00 a.m. on July 7, and at 9:30 a.m. on July 8 and 9, and will be held each day in the main Committee hearing room, 1100 Longworth House Office Building.

In announcing these hearings, Chairman Rostenkowski stated: "The Committee on Ways and Means has always discharged its responsibilities under the Congressional Budget Act. Beginning with the first reconciliation instruction to the Committee in 1980, the Committee has performed its budgetary duties in a responsible manner. The Federal budget deficit is the most serious fiscal problem confronting the nation. It presents a significant threat to the stability of our economy and is a major factor contributing to our record trade deficits and escalating foreign debt. Now that a budget conference report has been adopted and the reconciliation instructions are operative, it is essential that both the President and the Congress leave partisan rhetoric and posturing behind, and act responsibly in the nation's best interest to address the enormous problem of the Federal budget deficit.

"As Chairman of the Committee on Ways and Means, I fully recognize the need for stability in the Federal tax system after enactment of four major income tax bills in the last six years, culminating with the Tax Reform Act of 1986. Nevertheless, I am confident that the Committee on Ways and Means will fully comply with the reconciliation instructions contained in the budget resolution, with a balanced revenue bill that does not disrupt the delicate compromises of last year's Tax Reform Act and does not ask low- and middle-income taxpayers to shoulder the full burden of deficit reduction. To produce a reasonable and responsible bill will require our collective best efforts -- bipartisan cooperation in the Congress and the active support of the President. It is time for the President to join us, as he did throughout the tax reform process, in demonstrating to the American people that government can work. Although I do not underestimate the difficulty of the Committee's task, we will succeed, as we did in 1986, if partisan advantage is submerged to the national interest."

The Committee solicits testimony on specific proposals to increase revenues only, including: (1) the Administration's revenue increase proposals contained in the President's Budget for Fiscal Year 1988; and (2) the revenue options contained in the hearing pamphlet which will be available from the Government Printing Office. The revenue options described in the hearing pamphlet are presented for consideration by the Committee in connection with the reconciliation requirements relating to the revenue targets contained in the Budget Resolution for Fiscal Year 1988. Although the revenue options include those submitted by Members of the Committee, none of the options should be considered as formal recommendations of Chairman Rostenkowski, any other Member of the Committee on Ways and Means, or the staff.

The Chairman emphasized that the Committee will not receive testimony on proposals that reduce revenues. However, the Committee encourages witnesses to present other revenue-increase options beyond those proposed by the President or identified in the hearing pamphlet. Similarly, witnesses who oppose specific items in either the President's proposals or the hearing pamphlet are strongly encouraged to propose alternatives for the Committee's consideration.

The hearing pamphlet, being prepared by the Committee's tax staff and the Joint Committee on Taxation, will be available for sale to the general public at the GPO bookstore, or by calling the Superintendent of Documents at (202) 275-3030 and referring to Description of Possible Options to Increase Revenues, Jacket No. 74-267.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than the close of business, Wednesday, July 1, 1987, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearings. All persons requesting to be heard, whether scheduled for oral testimony or not, will be notified by telephone as soon as possible after the filing deadline.

Persons and organizations having a common position are urged to make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist. All witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

For those who wish to file a written statement for the printed record of the hearings, six (6) copies are required and must be submitted by the close of business, Wednesday, July 15, 1987, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements may be furnished for distribution to the press and the interested public if supplied to the Committee office, 1102 Longworth House Office Building, during the course of the hearings.

SEE FORMATTING REQUIREMENTS BELOW:

COMMITTEE ON WAYS AND MEANS FORMATTING REQUIREMENTS FOR PRINTING OF HEARING STATEMENTS, WRITTEN COMMENTS AND EXHIBITS

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

FOR IMMEDIATE RELEASE
THURSDAY, JULY 2, 1987

PRESS RELEASE #14
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U. S. HOUSE OF REPRESENTATIVES, ANNOUNCES AN ADDITIONAL HEARING DAY ON REVENUE INCREASE OPTIONS TO HEAR TESTIMONY FROM MEMBERS OF CONGRESS

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U. S. House of Representatives, today announced that the Committee will hold an additional hearing day to receive testimony from Members of Congress on revenue increase options.

The hearing will be held on Wednesday, July 15, 1987, at 10:00 a.m. in the Committee's main hearing room, 1100 Longworth Building.

Only testimony from Members of Congress will be heard on July 15. No additional requests to be heard, other than those which were received prior to the original cutoff date, July 1, 1987, will be entertained. All other details and requirements pertaining to the hearings remain as outlined in the earlier press release on this subject. (See Press Release #13, dated June 25, 1987.)

* * *

Mr. PICKLE The Chair will ask the committee to please come to order. Will our guests please find seats?

The Chair welcomes this nice crowd this morning. It shows an interest in the subject before us.

Today the committee begins 3 days of hearings to receive public testimony on options to raise revenue pursuant to the reconciliation instruction contained in the concurrent resolution on the budget for fiscal year 1988. The chairman has also announced that the committee will receive testimony from members of Congress on July the 15th.

The budget resolution directs this committee to raise a total of $64.3 billion in new revenue over the next 3 fiscal years. In preparation for meeting this reconciliation requirement, the committee has published a pamphlet describing possible revenue-raising options. Some of these options were proposed by the President in his budget for 1988; some were suggested by members of this committee; and others have been developed by the staff.

Witnesses have been directed by the chairman to confine their testimony to specific revenue-increasing proposals, either those described in the hearing pamphlet or new revenue-raising ideas which witnesses wish to bring to the attention of the committee. Unfortunately, severe time constraints require us to ask each witness, other than Treasury, to limit oral testimony to no more than 5 minutes. So please summarize your statements. Your full written statements will be placed in the hearing record.

Without objection, the press release announcing these hearings will also be made a part of the record.

Our first witness this morning is Mr. Dennis Ross from the Treasury Department.

Mr. GRADISON. Mr. Chairman?

Mr. PICKLE. Yes, Mr. Gradison.

Mr. GRADISON. Would it be appropriate to make a brief initial statement, Mr. Chairman?

Mr. PICKLE. Yes. Mr. Gradison.

Mr. GRADISON. Thank you very much, Mr. Chairman.

Mr. Chairman, I certainly want to commend the staff on the outstanding job they have done in preparing the options paper—more accurately, I guess I should say the options book—which is before us today. It certainly includes everything but the kitchen sink in terms of ways to raise revenues.

From what I hear, I think the options book is having a very unsettling effect. It is giving the impression to many people who may not be that sophisticated in the ways of Washington that the decisions that were made in the tax field just a year ago may be changed. The impression is that the ground rules may not stay in place. I think that is a false impression.

I am not at all convinced that tax increases lie ahead. I think that it is extremely important at the outset of these hearings to make it clear that there is not unanimity within the committee. The lack of unanimity is not just with regard to which specific tax increases should be chosen, but also with regard to whether it is wise public policy to impose upon the American people an $18 or $19 billion yearly increase in taxes at a time when the ink is barely dry on the major Tax Reform Act of 1986.

I look forward to the hearings, as we all do, Mr. Chairman. I know that there has been a lot of hard work carried out not only by our staff but also by those who prepared for these hearings. However, I think this is a time when it is useful to have modest expectations because my hunch is that the results are going to be quite modest when the whole exercise is over.

Thank you, Mr. Chairman.

Mr. PICKLE. Thank you. Mr. Matsui, would you care to make any opening statement?

Mr. MATSUI. I will be very brief, Mr. Chairman.

I would like to respond to Mr. Gradison. I do not think there is any question that we have to deal with the budget deficit. The deficit will be about $180 billion this year unless we come up with revenues or cuts in spending.

As long as the President is in an uncooperative and confrontational mode, you are right, this exercise here might be somewhat meaningless. We are probably going to see some kind of reform of the Gramm-Rudman law to perfect it; and if automatic sequestration occurs, then the work of this committee will be vitally important. The President will then be forced to negotiate revenue options and budget cuts with us. If he fails to do so, one of his pet projects, the increase in the defense budget will be under consideration and he will, by necessity, be prompted to discuss revenue options.

Mr. PICKLE. The Chair will proceed with witnesses. We have a panel list of approximately five groups today, and we want to move along as quickly as possible. We cannot recognize all members of the committee, but I think this Chair would simply want to add this observation:

We have been directed by the Budget Committee to raise a certain amount of revenue. That budget has been passed by the House. We have a budget, and these are targets that we will strive to meet. Whether there is unanimity in the committee for such tax raises is something that remains to be seen. But it appears we see very little cooperation by the President. So I think the Congress simply must make up its minds, particularly this committee, whether we move forward or not.

I think we have to decide what we think is right and what is best for the country. Regrettably, it seems like we will have to make that decision on our own without cooperation from the administration.

Regardless of your attitudes or your position, it is time for us now to hear the various groups and agencies over the country and have their viewpoints. Our first witness this morning is Mr. Ross who is the tax legislative counsel for the Department of the Treasury.

Mr. Ross, we will be pleased to hear from you. Now, we have your statement. Do you care to follow the statement? You are not limited to the 5 minutes.

STATEMENT OF DENNIS E. ROSS, TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. Ross. Thank you, Mr. Chairman. I request that my written statement appear in the record, and I will keep my oral remarks very brief.

I am pleased for the opportunity to appear before this committee. It should come as no surprise that I am here to reiterate the President's opposition to new taxes. The President has made clear specifically his opposition to the budget reconciliation resolution and its inclusion of substantial tax increases over the next three fiscal years.

The President's opposition to new taxes represents his firm belief that the American people and the American economy are not undertaxed, and that the solution to the problem of the deficit lies in restraining government spending and the overall size of Government.

Moreover, it is extremely important that we not undo the tax reform changes that were accomplished less than 1 year ago. Any increase in taxes should be viewed as a breach of the pact reached last year to return to the American people, in the form of lower tax rates, any increases in revenue that would otherwise accrue from making the tax base broader and more fair.

With these considerations in mind, the President's budget for fiscal year 1988 proposed various revenue initiatives that involved the collection of taxes owed but not currently paid, reform of certain of the current trust funds, and reasonable user fees for Federal programs that deliver services to identifiable beneficiaries. None of these revenue initiatives constitutes a general tax increase for the American taxpayer. Rather, they represent a strengthening of our present system and the elimination of certain unwarranted exceptions under current law.

Mr. Chairman, my written statement contains a further explanation of the revenue initiatives in the President's budget, and since these subjects were also covered in Assistant Secretary Mentz's testimony before this committee last February, I will not discuss in my oral remarks the specifics of these proposals except to note that the administration continues to support each of them.

I would, however, like to address very briefly the merits of the proposal contained in the President's budget to extend employer liability for FICA taxes to cash tips paid to employees. In a markup before Mr. Jacobs' subcommittee that occurred last week, a number of members of this committee expressed concern over the administrative burdens this proposal might present for employers.

Although I can understand that concern, I think it bears emphasizing that, as a practical matter, employers already are required to account for their employees' tips as wages since employers have both reporting and withholding obligations with respect to such amounts. Imposition of employer FICA tax on cash tips should, thus, not involve significant recordkeeping burdens and would eliminate an unwarranted subsidy for tip income.

Again, Mr. Chairman, there is in my written statement a more detailed discussion and explanation of the revenue initiatives contained in the President's budget. I will with that simply conclude my oral remarks, and I will be happy to respond to any of your questions.

[The statement of Mr. Ross follows:]

Release Upon Delivery
Expected at 10:00 a.m.,
July 7, 1987

STATEMENT OF
DENNIS E. ROSS
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am here today at your request to reiterate the Administration's support for certain revenue initiatives included in the President's fiscal year 1988 budget proposal. The Administration continues to support the $6.1 billion of additional governmental receipts shown in the President's budget proposal. The President has made clear his opposition to H. Con. Res. 93, the budget reconciliation resolution, and its inclusion of substantial tax increases over the next three fiscal years. As a representative of the Administration, my testimony, of course, will be consistent with this position. Accordingly, I will confine my remarks to the revenue initiatives included in the President's fiscal year 1988 budget proposal.

The Administration believes that it is extremely important that we not undo any of the dramatic and important tax reforms that were accomplished last year. Any increase in taxes should be viewed as a breach of the pact reached last year to return, in the form of dramatically lower tax rates, any increase in revenue that would otherwise accrue from making the tax base broader and more fair.

With this in mind, the Administration's Budget for Fiscal Year 1988 proposed various revenue initiatives that involve:

collection of taxes owed but not paid;

reform of certain trust funds; and

reasonable user fees for Federal programs that deliver services to identifiable beneficiaries.

None of these revenue initiatives constitutes a general tax increase for the American taxpayer. Rather, the proposals represent a strengthening of our present system and the elimination of certain unwarranted exceptions under current law.

On February 3 of this year, Assistant Secretary of the Treasury for Tax Policy J. Roger Mentz had the opportunity to appear before this Committee to discuss each of the proposed revenue initiatives. In this statement, I will reiterate the Administration's rationale for each of the revenue initiatives, which we continue to support within the framework of the Administration's fiscal year 1988 budget proposal.

Extend Medicare Hospital Insurance Coverage to all State and Local Government Employees

Background

State and local government employees who began work after March 31, 1986 are covered by Medicare Hospital Insurance, and a tax is imposed on both the employee and the employer to pay for this benefit. The rate of tax for 1987 is 2.9 percent of the

employee's wages (up to $43,800), paid half by the employer and half by the employee. An employment tax for medicare is not imposed, however, on the wages of State and local government employees who were hired before April 1, 1986.1/ Nonetheless, roughly 75 percent of such employees receive Medicare coverage because of eligibility through a spouse or because of a prior period of work in covered employment. Medicare coverage is mandatory for Federal employees, regardless of when hired.

Proposal

The Administration proposes to extend Medicare coverage to State and local government workers hired before April 1, 1986.

Discussion

Extension of Medicare coverage to State and local government employees hired before April 1, 1986, who are the only major group of employees in the United States not participating fully in Medicare, would ensure that the 25 percent of such employees who are not currently covered receive the benefits of Medicare. Such a change also would eliminate the charge to the Medicare trust fund caused by the fact that most State and local employees, even though they are not subject to the payroll tax, are nevertheless covered by Medicare.

Revenue Impact

We estimate that this change in Medicare coverage, proposed to be effective January 1, 1988, will increase receipts by $1.6 billion in the 1988 fiscal year.

Expand Employer's Share of Social Security Taxes to Include All Cash Tips

Background

Under Chapter 21 of the Internal Revenue Code of 1986 (the "Code"), relating to Federal Insurance Contribution Act ("FICA") taxes used to fund the Social Security system, a tax is imposed on the employee and the employer, based on the wages paid to the employee. In general, the tax imposed on the employee and the employer is equal. The employer is responsible for withholding the employee's share of the tax from the employee's wages and remitting the tax, together with the employer's share of the tax, to the Internal Revenue Service. The current tax rate for both the employer and the employee is 7.15 percent of wages, consisting of 5.7 percent for Old-Age, Survivors and Disability Insurance and 1.45 percent for Medicare Hospital Insurance.

Section 3121(q) of the Code provides that for purposes of chapter 21 of the Code, other than the tax imposed on employers, tips received by employees are considered remuneration for services and are subject to the FICA tax imposed on employees. The tips are generally deemed to be received at the time the employee files a written statement with the employer reporting the receipt of the tips, as is required under section 6053 of the Code.

1/States and localities are authorized to extend Medicare coverage to employees hired before April 1, 1986, if they enter into a voluntary agreement with the Department of Health and Human Services.

The full amount of tips received by an employee is not, however, usually subject to the FICA tax imposed on the employer. Under section 3121(t) of the Code, if an employer pays an employee wages that are below the Federal minimum wage, and the employee also receives tips in the course of his or her employment, the employee is deemed to receive wages equal to the Federal minimum wage for purposes of the employer's share of FICA taxes. Any tips received in excess of the difference between the wages paid and the minimum wage, however, are not subject to the employer's portion of the tax.

To illustrate the effect of this rule, assume that an employee earns $6.25 an hour as a waiter, consisting of $2.25 an hour in wages and $4.00 an hour in tips. The employee is required to pay social security tax on the full $6.25 an hour, subject to the applicable wage base limitation. The employer is only required to pay the tax on the Federal minimum wage, currently $3.35 an hour, rather than the full $6.25 an hour.

Proposal

The Administration proposes that all cash tips be included within the definition of wages for purposes of the employer's share of FICA taxes. Thus, employers would be required to pay FICA taxes on the total amount of cash tips (but, obviously, not in excess of the Social Security wage base).

Discussion

Requiring the employer to pay FICA taxes on the same amount of wages as does the employee--salary plus tips--follows the general structure of Chapter 21 that requires an equal tax to be paid by both parties. This proposal would thus eliminate the advantage currently enjoyed by some employers (those whose employees receive a portion of their wages by means of tips) and not by other employers.

In addition, employees under present law earn Social Security credit for the full amount of tips received, while the employer's share of FICA taxes is usually based on a smaller amount. In effect, the Social Security trust fund is subsidizing the employer to the extent of the employer's share of FICA taxes on any tips received by an employee in excess of the difference between the employee's wages and the Federal minimum wage. The fact that the employer does not directly pay the tips to the employee should not excuse the employer from payment of its share of FICA taxes. In substance, tips received by employees are the economic equivalent of wages and should be taxed in the same manner.

Present law regarding tips also creates an administrative burden for the Social Security Administration ("SSA") because separate records must be kept of the amount of reported tips for tax accountability purposes. Each year the U.S. Treasury transfers to the Social Security trust fund the amount of FICA taxes due on the total wages reported to the SSA during the prior year. Because no FICA taxes are paid by the employer on tips (other than the amount necessary to bring the employee's salary up to the minimum wage), the SSA must keep a separate record of tips so that it will be able to report to the Treasury Department with respect to the total amount of wages on which both employer and employee taxes are due and the total amount on which only employee taxes are due.

Revenue Impact

We estimate that the inclusion of the full amount of cash tips in the definition of wages for all purposes, proposed to be effective January 1, 1988, will increase receipts in the 1988 fiscal year by $0.2 billion.

Extend Social Security Coverage to the Inactive Duty Earnings of Armed Forces Reservists and to Earnings of Certain Students, Agricultural Workers, Individuals Aged 18-21 Who Work for their Parents, and Individuals Who Work for their Spouses

Background

Social Security taxes are imposed on the "wages" of an employee received as remuneration for "employment," both terms being defined in section 3121 of the Code. An employee only receives Social Security credit for his earnings if his salary constitutes wages under section 3121 and if his job is included in the definition of employment ("covered employment").

Armed Forces Reservists. Approximately 1.4 million Armed Forces reservists do not receive Social Security credit and are not subject to Social Security taxes for their inactive duty earnings, because "inactive duty training" (generally, weekend training drill sessions) has not been included as covered employment under section 3121. Earnings from full time active duty or from "active duty for training" (training sessions lasting several weeks) constitute covered employment under current law.

Students. Services performed by a student under various circumstances in an academic setting are excluded from coverage under Social Security and the student's wages are not subject to FICA taxes. Such students include those employed by a school they are attending (or college club or an auxiliary nonprofit organization of a school) and student nurses employed by a hospital or nurses' training school they are attending.

Agricultural Workers. Under present law, cash remuneration paid to an employee in any taxable year for agricultural labor is excluded from the definition of wages unless the employee receives more than $150 during the year for such labor or the employee works for the employer more than 20 days during the year.

Individuals Aged 18-21. Services performed by individuals under age 21 who are employed by their parents, even if employed in the parents' trade or business, do not currently constitute covered employment.

Spouses. Services performed by an individual in the employ of his or her spouse do not constitute covered employment.

Proposal

The Administration proposes to include services performed by reservists in "inactive duty training," by students employed by their educational institution, by individuals aged 18-21 working for their parents in a trade or business and by individuals working for their spouses in a trade or business, in the definition of covered employment. The Administration also proposes, with respect to agricultural labor, that: (a) any remuneration for agricultural labor paid by an employer to an employee constitute wages if the employer pays more than $2,500 to all employees for such labor during the taxable year, (b) the $150 annual cash pay test continue to be applied if the $2,500 annual payroll test is not met, and (c) the 20-day test be eliminated.

Discussion

Armed Forces Reservists. The proposal to include inactive duty training, commonly called monthly drill training, within the definition of covered employment would improve social security

protection for reservists. Such training was not originally included in the definition of covered employment for two reasons: (1) because most reservists were covered under Social Security through their regular work, coverage of monthly drill training, which involved very small amounts of pay, would have resulted in little additional Social Security protection for reservists; and (2) reporting pay for monthly drill training would have imposed an undue administrative burden on reserve units.

These reasons for not covering inactive duty training are no longer compelling. The pay for monthly drill training is now substantial. Such drill pay accounts for approximately 70 percent of a reservist's annual reserve earnings. Generally, a reservist is required to train at least one weekend monthly. Drill pay ranges from approximately $1,000 to $3,800 a year for enlisted members and from $1,700 to $9,000 for officers.

The proposal would not create an administrative burden for reserve units, because they now withhold Federal income taxes from wages paid to reservists for all services, including inactive duty training. Indeed, because reservists' pay would be treated the same for Social Security and Federal income tax purposes, the proposal would reduce reporting complexities.

Students. The reason for excluding certain student services from the definition of covered employment was that the small amount of protection students would gain would not be proportionate to the wage reporting and tax payment burden imposed on their employers. However, because in most instances the employer is now required to withhold income taxes from such earnings and because payroll practices have become more sophisticated, the administrative burden placed on employers by the proposal is not unreasonable.

Furthermore, students employed by their educational institutions need the protection of the Social Security program as much as other workers. Because of this exclusion, students may not gain any Social Security protection or may have gaps in their protection. This is important because features have been added to Social Security that are particularly desirable for younger workers (e.g., disability benefits and Medicare for the disabled). Finally, changes in the student population itself have increased the students' need for protection--students today are older, stay in school longer and are more likely to be married and have children.

Agricultural Workers. The proposal to adopt an annual $2,500 threshold test for agricultural employers would result in the coverage of more than 95 percent of the remuneration paid to all farm workers and would improve the Social Security protection afforded to about three-quarters of a million farm workers and their dependents. The proposal will not unreasonably increase the recordkeeping burden of farm employers. In particular, farms with expenditures in excess of $2,500 for farm wages will in all likelihood already report wages for Social Security purposes for at least some employees who meet the coverage test under current law. These employees will thus already be familiar with Social Security tax recordkeeping. The 20-day test would be eliminated under the proposal because, due to increased wage levels for farm work, employees will normally meet the $150 test well before working for 20 days.

Individuals Aged 18-21. Individuals between the ages of 18 and 21 who are employed by their parents cannot acquire the Social Security coverage which is available to other employees of the same age who perform the same or similar services for employers other than their parents. Changing the law to provide coverage for an individual aged 18 or older employed in his or her parents' business also would eliminate a potential tax avoidance device whereby self-employed persons may be able to use the present coverage exclusion to reduce their own Social

Security taxes. Under present law, the self-employed person can take the position that paying a child under age 21 a large salary, which is not subject to the Social Security tax, and claiming the salary as a business deduction, will thereby reduce the amount of the parent's income that is subject to the Social Security self-employment tax.

Spouses. Under current law, an employee spouse is not covered under Social Security in the same manner as other employees. The employee spouse, even one who has some prior earnings from covered employment, may not have disability protection and will have reduced retirement protection. More significantly, in cases where the employee spouse had no prior earnings from covered work, the employee spouse will have no Social Security protection in his or her own right. Accordingly, if the spouses were to divorce within ten years of marriage, the employee spouse would lose eligibility for Social Security auxiliary or survivor benefits and would have no protection despite years of employment. The Administration's proposal would provide a married person who is actually performing services and being paid wages as an employee of his spouse with protection under the Social Security system.

The exclusion for an employed spouse also lends itself to a tax avoidance device, similar to that described above for children, under which a married couple working together in a business may attempt to reduce their Social Security tax liability by paying a large salary to the employed spouse, thereby lowering the amount of self-employment income taxable and creditable to the other spouse. The proposal to repeal the exclusion for such wages removes this potential artificially to lower FICA tax payments when a couple operates a business together.

Revenue Impact

The changes in Social Security coverage described above, proposed to be effective January 1, 1988, are estimated to increase receipts by $0.2 billion in fiscal year 1988.

Treat Employer-Provided Group-Term Life Insurance as Wages for Purposes of Social Security Taxes

Background

The value of group-term life insurance coverage provided to an employee is excluded from the definition of "wages" in section 3121 of the Code. For income tax purposes, however, the value of such insurance, other than the cost of the first $50,000 of coverage provided to an employee, is included in taxable income. Moreover, if the insurance coverage is provided to employees in a manner that discriminates in favor of key employees, then the entire cost of the coverage is included in taxable income of the key employees.

Proposal

The Administration proposes to conform the treatment of group-term life insurance for Social Security tax purposes to its treatment under the income tax. Accordingly, the cost of group-term life insurance would be included in the definition of wages for purposes of FICA taxes if the cost were taxable to the employee.

Discussion

The proposal would treat the provision of group-term life insurance the same for both FICA and income tax purposes. There

is no Social Security program rationale for the unlimited exclusion of this employee fringe benefit. The FICA tax status of certain other fringe benefits, such as group legal services, meals and lodging, educational assistance, and dependent care assistance, has similarly been tied to the income tax status of such benefits.

Revenue Impact

We estimate that the inclusion of certain group-term life insurance in the definition of wages, proposed to be effective January 1, 1988, will increase revenue by $43 million in fiscal year 1988.

Repeal Certain Exemptions from Gasoline and Other Highway Excise Taxes

Background

The Highway Trust Fund, which is used to finance Federal assistance for highways and for mass transit systems, is funded by highway user fees, including excise taxes on gasoline, diesel fuel and tires, a sales tax on heavy trucks and trailers, and a heavy truck highway use tax.

Although the Highway Trust Fund is intended to be funded by all who use the nation's highways, there are several exceptions to this general rule. In particular, gasohol and certain other alcohol fuels, as described below, are partially exempt from the excise taxes on gasoline and diesel fuel. State and local governments are fully exempt from all Federal highway excise taxes. Public bus operators are fully exempted from Federal gasoline, diesel fuel, and other highway excise taxes. Private bus operators are fully exempt from the excise tax on tires and are partially or fully exempt from certain other excise taxes.

Proposal

The Administration proposes to repeal the exemptions from the highway excise taxes described above.

Discussion

Alcohol Fuels. Under current law, the general tax rate is 15 cents per gallon for diesel fuel and 9 cents per gallon for gasoline and special motor fuels. An exemption of 6 cents per gallon is provided for gasohol and certain alcohol fuels (neat methanol and ethanol fuels that contain 85 percent or more alcohol) produced from a substance other than petroleum or natural gas, and an exemption of 4 1/2 cents per gallon is available for such alcohol fuels produced from natural gas. The exemption of gasohol and alcohol fuels from the excise taxes for highway use distorts the allocation of resources. It also encourages users to purchase fuels that have a higher economic cost than alternative fuels because the tax system lowers the cost of the subsidized fuel. Moreover, the exemptions allow users of the highways to escape paying their fair share of the applicable use taxes. Accordingly, the Administration proposes to repeal these excise tax exemptions. (The Administration does not propose that the alcohol fuel tax credit, described in section 40 of the Code, be repealed).

Bus Operators, State and Local Governments. Highway trust fund taxes are designed to charge users of the public highways for the wear and tear they cause and for the Federally funded highway improvements made for their benefit. The exemptions for bus operators and for state and local governments are inconsistent with having all highway users paying their fair share of the cost of maintaining and improving our highway system.

Revenue Impact

We estimate that the repeal of these special exemptions, proposed to be effective October 1, 1987, will increase receipts by $0.6 billion in fiscal year 1988.

Increase Excise Tax on Coal Production; Treat Black Lung Income Replacement Benefits as Taxable Income

Background

The Black Lung Disability Trust Fund, which provides benefits to individuals (and their survivors) disabled by pneumoneucleosis (black lung disease), is funded in part by an excise tax on the sale of coal by producers. The current rate of tax is $1.10 per ton for coal from underground mines and $.55 per ton for coal from surface mines, with a cap of 4.4 percent of the sales price for each ton of coal produced. The Trust Fund is presently $2.9 billion in debt, even though the Federal government has assumed responsibility through the General Fund for paying $1 billion a year in income replacement benefits for some miners whose benefits are distributed by the Social Security Administration from general revenues. Moreover, the General Fund is currently bearing the interest costs on the amounts the Trust Fund has borrowed.

Under section 104(a)(1) of the Code, black lung replacement income benefits are excluded from taxable income.

Proposal

The Administration proposes to increase the excise tax on the sale of coal by producers to $1.70 per ton for coal from underground mines and $.85 per ton for coal from surface mines, subject to a cap of 6.8 percent of the sales price. This rate would apply through 1990, with decreasing rates thereafter. The Administration also proposes to repeal the requirement that the General Fund bear the interest costs incurred by the Trust Fund, and proposes that black lung replacement income benefits be included in taxable income.

Discussion

The excise tax proposed by the Administration is necessary to reduce and eventually to eliminate the deficit in the Trust Fund. The Administration's 1988 budget proposes certain changes to slow the growth of black lung benefit payments, including a one-year freeze on cost-of-living adjustments for benefits. Because benefit changes alone will not permit retirement of the Trust Fund's indebtedness, however, the excise tax on coal must be increased to restore the Trust Fund to solvency.

The exclusion of black lung income replacement benefits from taxable income is inappropriate because it allows income that is merely replacing taxable income to escape tax.

Revenue Impact

The increased tax on coal production and sale, proposed to be effective October 1, 1987, will increase fiscal year 1988 receipts by $0.3 billion. The inclusion of black lung replacement income benefits in income, proposed to be effective January 1, 1988, will increase fiscal year 1988 receipts by $21 million.

Increase Contributions to the Rail Industry Pension Fund; Extend Federal Unemployment Tax to Railroad Employment

Background

The rail industry pension fund is financed primarily by payroll taxes imposed on covered employers and their employees. Under present law, both the employer and the employee pay a "Tier I" tax that is equivalent to the Social Security taxes. In addition, a "Tier II" tax is paid by both the employer and the employee. The current rate of the Tier II tax is 14.75 percent for employers and 4.25 percent for employees, computed on the first $32,700 of the employee's salary.

Railroad employment is not presently covered by the Federal-State unemployment insurance system. Railroad employees are covered by a separate Railroad Sickness and Unemployment Fund, which is financed by payroll taxes levied on rail employers. The Fund has been insolvent for 22 of the last 27 years. It currently owes approximately $800 million to the rail pension fund.

Proposal

The Administration proposes to increase railroad retirement Tier II taxes by a total of 1.5 percentage points effective January 1, 1988, and by an additional 1.5 percentage points effective January 1, 1989. This increase will be shared by the employer and the employee. Railroad workers would become covered under the Federal-State unemployment insurance system beginning with transitional coverage on October 1, 1987. Railroads would begin paying taxes under the Federal Unemployment Tax Act effective January 1, 1988.

Discussion

Financing legislation for the rail industry pension fund enacted in 1974, 1981, and 1983 was based on certain assumptions as to the level of railroad employment and the level of pension contributions necessary to keep the Fund solvent. Those assumptions have proven to be incorrect and an increase in rail pension contributions, as recommended by rail pension actuaries, is needed in order to ensure the solvency of the Fund. Bringing rail employees within the Federal-State unemployment insurance system would result in these employees receiving the same unemployment insurance benefits as do other employees. This proposal would repay the $800 million debt to the rail pension fund.

Revenue Impact

We estimate that the additional pension fund contributions, proposed to be effective January 1, 1988, and again on January 1, 1989, will increase receipts by $0.1 billion in fiscal year 1988 and $0.3 billion in fiscal year 1989. We estimate that coverage of rail employees under the Federal-State unemployment insurance system, beginning with transitional coverage on October 1, 1987, will increase receipts by $0.1 billion in fiscal year 1988.

Repeal the Windfall Profit Tax

Background

Under current law, an excise tax is imposed on domestically produced crude oil. Taxable crude oil is classified in three tiers. Generally, oil in tier one is "old" oil that had been subject to price controls; oil in tier two consists of oil produced by a stripper well, plus petroleum reserve oil; and oil in tier three is newly discovered oil, tertiary oil and heavy oil. The base for the tax is the difference between a statutory base price (lower for tier one oil and progressively higher for tiers two and three), adjusted for inflation, and the amount for

which oil is sold, less a severance tax adjustment. The tax rate is 70 percent for tier one oil, 60 percent for tier two oil, and 30 percent for tertiary oil and heavy oil. The tax rate for newly discovered oil is 22-1/2 percent through 1987, 20 percent for 1988 and 15 percent for 1989 and thereafter. Independent oil producers are taxed at a 50 percent rate for tier one oil with respect to 1,000 barrels per day of production and are exempt from the windfall profit tax on stripper well oil.

The windfall profit tax is scheduled to phase out over a 33-month period beginning in January 1991, or the first month after December 1987 in which cumulative net receipts exceed $227.3 billion, whichever date occurs first.

Proposal

The Administration proposes to repeal the windfall profit tax.

Discussion

The windfall profit tax was enacted in 1980 when a dramatic increase in the price of domestic crude oil was expected due to the decontrol of that price. Although the price of domestic oil did initially reach record highs, in recent months the price of oil has dropped so much that it is now below its pre-decontrol level (when adjusted for inflation). Consequently, little or no windfall profit tax is being collected, and the tax itself is, therefore, no longer appropriate. Even if crude oil prices again rise to levels that would generate significant profits for domestic oil producers, such profits would, in no way, be considered "windfall" profits. This is because a return to a profitable situation for domestic oil producers would be the result solely of market conditions (here and abroad) and not the result of the government lifting an artificial price barrier, as was the case when the tax was first imposed.

In general, the Tax Reform Act of 1986 was designed to produce uniform rates of taxation on the income generated in different activities, and to eliminate tax-induced distortions in investment. Repeal of the windfall profit tax is consistent with that objective.

Revenue Impact

Under the Administration's current oil price projections, the repeal of the Windfall Profit Tax would not have any revenue impact in 1988, or at any time prior to 1991.

Revise Customs Users Fee

Background

In 1986, Congress enacted an ad valorem user's fee on imports. The rate of the fee is 0.22 percent of value in 1987, dropping to 0.17 percent in 1988. For 1989, the Secretary of the Treasury is authorized to reduce the fee so that the amount realized is equal to the amount necessary for salaries and expenses for the commercial operations of the Customs Service. The fee is scheduled to expire on September 30, 1989. The reason for enacting this fee was to ensure that the costs of services provided by the U.S. Customs Service are borne by the users of those services and not by the general taxpayer. Accordingly, the proceeds of the fee are deposited into a dedicated Customs Service account and are available, subject to appropriations, exclusively for the funding of Customs costs in processing all commercial imports.

Particular goods, including those imported under Schedule 8

of the tariff schedules (which includes products containing U.S. components--item 807.000 in the Schedules), are exempt from the fee.

Proposal

The Administration proposes to provide the Secretary of the Treasury the authority to prescribe and collect fees, on any basis that the Secretary deems appropriate, for the provision of any Customs service performed in connection with the processing of any merchandise that is entered into the United States or admitted to a foreign trade zone, or withdrawn from a warehouse, foreign trade zone, or other bonded status. These fees would apply indefinitely, instead of expiring at the end of fiscal year 1989. In addition, the Administration proposes that the revised user fee will apply to all imports as determined by the Secretary of the Treasury, after consultation with the heads of other departments.

Discussion

The application and extension of the user fee to all imports entering the country is consistent with the concept that those who benefit from specialized government services should pay for them directly. Last year, Congress took the first important step by imposing an ad valorem fee, and the Administration now proposes the enactment of authority to permit the full recovery of Customs costs incurred while processing cargo.

Revenue Impact

The elimination of the exception for the goods listed in Schedule 8, proposed to be effective on July 1, 1986 (the effective date of the legislation enacting the fee), is estimated to increase receipts by $0.1 billion in the 1988 fiscal year.

Extend the Airport and Airway Trust Fund Excise Taxes

Background

The Airport and Airway Trust Fund provides money for airport construction, facilities and equipment for the air traffic control system, research and development, and Federal Aviation Administration operating expenses. The trust fund is financed by a variety of user fees, including excise taxes on airline fares, aviation fuel, and air shipments. These user fees are scheduled to expire on December 31, 1987.

Proposal

The Administration proposes to extend existing airport and airway user fees for an additional two-year period.

Discussion

Consistent with its position that the users of Federal services should help pay for such services, the Administration believes that the Airport and Airway Trust Fund should continue to be funded by means of user fees such as the excise taxes described above.

Revenue Impact

The revenues from the extension of the user fees described above is not reflected in the $6.1 billion of new revenues shown in the Administration's budget proposal because it is an extension of an existing tax.

Increase Internal Revenue Service Funding

Background

As a result of the Tax Reform Act of 1986, it is easier for taxpayers to pay the correct amount of taxes and for the Internal Revenue Service ("IRS") to determine how much each taxpayer owes. Nevertheless, a large gap still exists between the amount of taxes owed and the amount paid.

Proposal

The Administration proposes to increase IRS funding for the 1988 fiscal year.

Discussion

Increased IRS funding for the 1988 fiscal year will ensure the smooth implementation of tax reform, will improve enforcement of the tax laws, and will help close the gap between taxes owed and taxes paid.

Revenue Impact

We estimate that the proposed increases in IRS funding will increase receipts in the 1988 fiscal year by $2.4 billion.

Authorize PBGC to Charge Variable-Rate Premium for Underfunded Defined Benefit Plans and Improve Minimum Funding Rules

Background

Under present law, if a single-employer defined benefit plan is terminated with assets insufficient to pay benefits guaranteed by the Pension Benefit Guaranty Corporation ("PBGC"), the PBGC pays the benefits provided by the particular plan, up to the guaranteed levels. Subject to certain limits, the PBGC generally guarantees nonforfeitable retirement benefits other than those that become nonforfeitable on account of the termination of the plan and those for which employees have not, at the time of termination, satisfied all of the applicable conditions for eligibility. Despite the 1986 increase in the premium rate to $8.50 per participant and recent restrictions on the circumstances under which employers may terminate underfunded defined benefit plans and shift pension liabilities to the PBGC, terminations of underfunded plans in failing companies are projected to increase the PBGC's single-employer deficit from $3.8 billion at the end of 1986 to $5.1 billion by the end of 1988. Benefit payments to retired workers are estimated to exceed PBGC premium receipts and income in 1987.

Pension plans can be underfunded on plan termination for many reasons. One of the most important and least justified reasons, however, is that the minimum funding rules applicable to pension plans are not adequate in many circumstances to assure that a pension plan's assets are sufficient to provide employees' accrued plan benefits. As a result, on the termination of an underfunded plan, not only is the PBGC forced to pay unfunded employer-promised benefits--including benefits that the employer has not yet been required to fund--but, because the PBGC does not guarantee all accrued benefits, employees also may lose important retirement benefits.

Proposals

To address the PBGC deficit, the Administration proposes to authorize the PBGC to charge higher premiums to those employers who do not adequately fund their pension promises. The annual

premium payable by a single-employer defined benefit plan would consist of two elements. One element would consist of a flat per-participant charge applicable to all single-employer plans. The flat per-participant charge would be indexed annually to wage growth. The second element would be a variable-rate funding charge based on the difference between a funding target and the level of plan assets for plans with 100 or more participants. The total of these two premium charges would not exceed a maximum of $100 per participant for the 1988 plan year. The PBGC would be authorized to review the funding charge rate at 3-year intervals and could revise the rate by 50 percent either upward or downward without the need for Congressional action. A surcharge equal to a percentage of the funding charge otherwise due would be imposed for missed or waived contributions. The surcharge would not be taken into account in applying the annual limit on per-participant premiums ($100 for the 1988 plan year). The proposal would be effective January 1, 1988.

To address the long-term issue of defined benefit plan underfunding, the Administration also proposes to modify the termination liability and minimum funding rules for these plans to increase the accountability of employers for their pension benefit promises to employees. These proposals, which have been the subject of separate Administration testimony, would make an employer liable to employees and the PBGC for its unfunded pension promises on plan termination and would require that an employer more rapidly fund employees' benefits under an ongoing plan. The Administration considers these proposals to be essential not only to the long-term financial viability of the PBGC, but also to the security of employees' retirement benefits.

Revenue Impact

The PBGC estimates that the proposal to charge variable-rate premiums would result in PBGC outlay savings of $0.5 billion in fiscal year 1988.

Miscellaneous Provisions

Other revenue initiatives contained in the President's budget proposal, not discussed above, include user fees charged by the Internal Revenue Service including fees for the issuance of private letter rulings and determination letters ($60 million); increases in Nuclear Regulatory Commission fees ($73 million); initiation of Federal marine fishing license and other fees for commercial and recreational boating ($46 million); user fees for use of services provided by the Bureau of Alcohol, Tobacco and Firearms ($50 million); initiation of rail sector financing of a portion of windfall benefits ($92 million); increases in the contributions of the District of Columbia and its employees to civil service retirement ($10 million); and initiation of fees for the United States Travel and Tourism Administration ("USTTA") resulting in $10 million in receipts for the Treasury and $9 million of offsetting collections for USTTA.

Also, the President's budget proposal assumes a two-year extension of the pilot IRS tax refund offset program which is scheduled to expire on December 31, 1987. Under this program, the IRS is authorized to offset against a tax refund legally enforceable nontax debts owed other Federal agencies. Collections under this program in fiscal year 1988 are estimated to total $424 million.

* * *

This concludes my prepared remarks. I would be pleased to respond to questions.

Mr. PICKLE. Well, Mr. Ross, let me suggest that, while we appreciate your cooperation, I would hope you could do more than just blow a kiss at us this morning here. This is the most serious matter we have revenuewise that has faced the Congress in many years. And for you to mention just the extension of Medicare coverage to State and local employees to me is not quite enough. I would hope that you would be a little more expansive on the points you make.

We have your testimony, but we are just now seeing it for the first time. So the American people do not know what you are recommending other than increased FICA taxes.

Do you mind taking a few moments and mentioning some of the other things that you are recommending, or are you just against the whole effort?

Mr. ROSS. No, Mr. Pickle. The President and administration certainly remain firmly behind the revenue initiatives contained in his budget. My decision not to cover these in my oral remarks—which I am happy to reverse, by the way—was simply to reflect that, first of all, there was a detailed written statement and, I suppose more than that, that Assistant Secretary Roger Mentz, in testimony before this subcommittee last February, went over these same proposals. Essentially, our position on them has not changed since that time. The testimony, in fact, tracks very closely Mr. Mentz's testimony last February.

The basic highlights of those revenue initiatives are covered in my written statement, and they touch on a number of subjects: as you know, extending Medicare hospital insurance coverage to all state and local government employees; the cash tip FICA tax proposal which I alluded to in my own remarks; extending Social Security coverage to certain other categories of employment that are currently exempt and that would include certain service by Armed Forces reservists, certain student employment, agricultural employment.

Mr. PICKLE. Mr. Ross, before you tick off these items in block, what would your employer's share of Social Security, bring in new revenue?

Mr. ROSS. I am sorry. On the cash tip proposal?

Mr. PICKLE. This is the proposal to expand the employer's share of Social Security taxes to include all cash tips. I know that $1.6 billion revenue could be raised on the extension of Medicare coverage to the State and local employees. Now, how much revenue would you get out of the Social Security? Do you know?

Mr. ROSS. Yes. The figure is $0.2 billion for fiscal year 1988.

Mr. PICKLE. $22 billion——

Mr. ROSS. $0.2 billion.

Mr. PICKLE. $0.2. All right. That is a little different. $0.2 in 1988. All right. Let us take some of your other items.

Mr. ROSS. The sum of these revenue initiatives is $6.1 billion for fiscal year 1988.

Mr. PICKLE. How much do you get out of the agricultural workers?

Mr. ROSS. Yes, I do not know that that, Mr. Pickle, is broken out. In total, there would be $0.2 billion from extending the coverage to agricultural workers, students, Armed Forces reservists, and then the individual dependents aged 18 to 21 and spouses.

Mr. PICKLE. I see you would repeal certain exemptions from gasoline and other highway excise taxes.

Mr. ROSS. That is right, Mr. Chairman.

Mr. PICKLE. You mention repeal of the extension of exemptions. How much revenue would that bring?

Mr. ROSS. That is in toto, $0.6 billion, and that would include both certain exemptions for particular types of fuel and then exemptions based on the identity of the user, principally State and local governments.

Mr. PICKLE. All right. If we increase the excise tax on coal production, treat black lung cash benefits as taxable income, how much revenue would we raise?

Mr. ROSS. The increased excise tax would be $0.3 billion, and then I believe it is $21 million attributable to the treatment of the black lung income replacement benefits as taxable income.

Mr. PICKLE. All right. You would extend the Federal unemployment tax to railroad employment? What revenue would be raised?

Mr. ROSS. There are two pieces to that. The additional pension fund contributions would be $0.3 billion, and then bringing rail employees under the Federal-State unemployment system would be $0.1 billion.

Mr. PICKLE. Well, your testimony, I assume, is basically that you are against any tax of any kind except that you do recommend the proposition the President has advanced, and that is expansion of the unemployment tax, the coal excise tax, the black lung area and repeal of current gasoline excise tax exemptions.

Now, that is a total in over 3 years' time, as I recall, of about $21, $22 billion. Is that correct?

Mr. ROSS. Mr. Chairman, I do not really have the 3-year figure fresh in my mind. The fiscal year 1988 figure, I believe, is $6.1. I can get you the 3-year figure.

Mr. PICKLE. Well, the President keeps saying that he would veto any tax increase, yet his own budget, which you have just outlined for us, calls for about $22 billion of revenue increases over the next 3 years. Now, this is about one-third of the amount we are directed to raise by the budget resolution.

Has the President disavowed the call for tax increases that were a part of his budget? Or are we just arguing about how much of a tax increase and which taxes to increase?

Mr. ROSS. Well, Mr. Chairman, I think you had the right characterization of the budget proposals initially when you said they were revenue increases. We certainly do not deny that there are revenue increases in the President's budget.

We would, however, resist a characterization of these as tax increases. As I outlined very briefly in my——

Mr. PICKLE. Well, if the Congress made similar proposals like the President, they would be taxes, but not just revenue increases. How can you on the one hand call them revenue increases, but if we do it in the same general area it would be tax increases?

Mr. ROSS. Well, we would not resist the source of—we would not base the characterization on who is making the proposal. These same proposals made by the Congress would not be characterized by the President, I believe, as tax increases. It is the nature of the

proposals themselves which go not to imposing new taxes on the economy.

Mr. PICKLE. Is it your contention that what the President has recommended, $22 billion in taxes, are not taxes?

Mr. ROSS. They are not new taxes. They are, for the most part, better characterized, more accurately characterized as either user fees, or in some cases, increases in taxes necessary to fund——

Mr. PICKLE. Well, if the Congress were to raise a similar amount in so-called user fees, then we would be under the language of the President and that would be permitted?

Mr. ROSS. Well, I think you would want to look carefully at the nature of that proposal. I am not sure what other user fees could reasonably be raised and present revenue that could be spent for the targeted purposes that user fees are imposed for.

In each of these cases, where we have proposed an increase in user fee, I think it is generally related to a trust fund that is currently not solvent, and it is designed to address that problem.

Mr. PICKLE. Well, I find it difficult to accept the fact that when you make a recommendation to raise $22 billion you say it is called a revenue enhancer and you have to look at the nature of the tax; but if we do a similar thing on the congressional side, it is automatically a tax increase.

Now, Mr. Ross, that appears to be hypocrisy to me, and I think the Congress is going to examine the proposition that if it is a revenue raiser on one hand, then it ought to be on the other.

It would seem to me like we ought to have more cooperation from the administration. Let me give you an example. I understand that Treasury last week testified before the Select Revenue Committee in favor of taxing master limited partnerships as corporations. Now, would that raise a considerable amount of revenue.

Can you tell me how much that proposal would raise or whether or not the President supports that as a revenue raiser?

Mr. ROSS. Well, I think two things need to be noted there, Mr. Chairman. First of all, it was the Treasury's testimony that Congress should, in fact, consider such a classification, and we noted at that time the administration itself had that issue under review.

I think one of the issues the administration would look at is whether that would, in fact, constitute a new tax or tax increase. We ourselves——

Mr. PICKLE. Well, then——

Mr. ROSS. Just if I could conclude very quickly the thought, we ourselves viewed that not as a revenue initiative, not as a way to enhance the revenues, but really to protect a revenue base that was relied on in the tax reform process. But the administration itself is examining that question.

Mr. PICKLE. If the Treasury recommends a tax increase or other revenue raising recommendations, that does not count? That is, that is just the Treasury recommendation and not the administration's. How can Congress determine what is the President's recommendation? If you distinguish one from the other, we never know who has the ball or who is making the recommendation. So I would hope that as we move along in this area that we have a better understanding of what your position is.

Mr. ROSS. I can appreciate that, Mr. Chairman.

Mr. PICKLE. You cannot tell me if we were to put a tax on a master limited partnership would the President veto it?

Mr. Ross. Mr. Chairman, all I can tell you there is the administration is currently reviewing the issue, and I just cannot give you an answer.

To my knowledge, that is the only issue where the Treasury and the administration are not currently in agreement. Certainly, on the proposals I have just discussed, there is no question of the Treasury proposing and the administration not supporting.

Mr. PICKLE. Thank you, Mr. Ross.

Mr. Gradison.

Mr. GRADISON. No questions at this time, Mr. Chairman.

Mr. PICKLE. Mr. Matsui.

Mr. MATSUI. Yes, thank you, Mr. Chairman. I want to follow up on the master limited partnership issue.

You are saying, Mr. Ross, that Treasury—has no position on the master limited partnership, although they testified last week before Select Revenue Committee that they favored taxing master limited partnerships as corporations? I want a clarification here. I do not quite understand your ambiguities.

Mr. Ross. Well, I really did not mean to introduce any new ambiguities. The testimony last week was that Treasury believed, and still does, that Congress should consider taxing master limited partnerships as corporations.

Mr. MATSUI. I understand that. That is ambiguous. Should we consider it and not do it, or should we consider it and do it?

Mr. Ross. That ambiguity, I admit, was in the testimony last week, and it really has not changed.

Mr. MATSUI. Well, I think almost every tax publication I read said that Mr. Mentz favors taxing these corporations.

Mr. Ross. That is accurate, and the Treasury Department, I think, has that position. We noted at the time that the administration itself has the issue under review.

I think it bears emphasizing that we ourselves did not propose that as a revenue-raising proposal. We understand it has budget period revenue effects, but the purpose of the proposal was offered in the spirit not to enhance revenues, but to protect an existing revenue base.

Mr. MATSUI. So it is my understanding, then, if Mr. Mentz testified before the Select Revenue Measures Subcommittee again on the issue of master limited partnerships, he would say it is under review, we have no position at all. Is that correct?

Mr. Ross. Well, the Treasury's position is not under review, but the administration is reviewing that issue. In that case—and that is the only case I am aware of—I think you need to distinguish between Treasury and the administration.

Mr. MATSUI. OK. Would it be political considerations that you are reviewing, or are you really reviewing tax considerations?

Mr. Ross. Well, no, I think there are a number of considerations that would be involved in the administration's review. One would be perhaps this issue of whether or not it would be viewed as a new tax.

Mr. MATSUI. OK.

Mr. Ross. But there are other departments that are interested in the proposal.

Mr. MATSUI. Let us follow up on that. Let us say, then, that you all decide that master limited partnerships should, in fact, be taxed. All right? Let us say the limited partners and partners, the general partner under a master limited partnership then no longer can have a partnership tax consequence, but a corporate tax consequence. As a result of that, that individual's taxes go up.

Are you telling me that that is not a tax?

Mr. Ross. No. I would not tell you that.

Mr. MATSUI. Well, how do you come to the conclusion that it is not a tax?

Mr. Ross. Well, I did not mean to make that distinction with respect to the master limited partnership proposal.

Mr. MATSUI. Well, unless I misunderstood you when you answered a question put to you by Mr. Pickle, it sounded like you were saying it really was not a tax.

Mr. Ross. No, I meant that distinction to apply to the proposals in the President's budget, and I think the distinction there is sound.

I would not suggest the same distinction with respect to the Treasury Department's position on master limited partnerships. I think that could well be viewed as a tax increase. And, indeed, if the administration was to support it, it might insist that it proceed in a revenue neutral context.

Now, that is speculation on my part.

Mr. MATSUI. Wait a minute. If the administration supported it, it would be in a revenue neutral context?

Mr. Ross. Again, since the administration is just reviewing it——

Mr. MATSUI. What would you do? Come up with other taxes in order to offset it or decrease other taxes?

Mr. Ross. Well, I think it would be perhaps some reduction in other taxes. Again, I——

Mr. MATSUI. Oil and gas or what?

Mr. Ross. Well, the revenue involved there is relatively modest, so I do not know what exactly would be the companion piece.

Mr. MATSUI. Let me ask you one more question. With the exception of the matters raised in your written testimony, the administration and you could not support any of these 200-plus items in this pamphlet. Is this correct?

Mr. Ross. Mr. Matsui, that is the administration's position. Obviously, the President's proposals are themselves contained therein, and we continue to support those. Once you get beyond that, though, you are in an area where the administration does not support them.

Mr. MATSUI. And the reason you suggest that is because your proposal——

Mr. Ross. Mr. Matsui, could I make just one exception?

Mr. MATSUI. Yes.

Mr. Ross. The master limited partnership proposal, or some variations of it, are contained in there, and I would have to say the administration is reviewing that issue.

Mr. MATSUI. And you are saying that the reason you cannot support any of these items in here, with the exception of those that

you pulled out, is because it would have an adverse, negative effect on the U.S. economy?

Mr. Ross. Well, I think that is certainly part of it, an important part of it. The President's opposition to new taxes I think has a number of philosophical groundings, and that is certainly one.

Mr. MATSUI. If we deny tax credit to companies doing business in South Africa, would that have a negative effect on the U.S. economy? Or is that a policy issue?

Mr. Ross. Well, as I said, I think there would be a number of considerations as you went through each of the proposals. I think if you identified individual proposals it would be hard to say perhaps that that proposal, viewed in isolation, would have a significant adverse effect on the economy, but new taxes in general would have such an adverse effect.

Mr. MATSUI. Do you know how many votes the President got on his budget on the floor of the House and the floor of the Senate last month?

Mr. Ross. It was less than a majority, I know that.

Mr. MATSUI. There were 27 in the House and 18 in the Senate.

In view of that, what are you going to do? Let the Government go off the brink since no one is willing to try to reach a consensus?

Mr. Ross. I really cannot predict the outcome of the process, and I do not know what exact steps the administration anticipates. But I have no doubt of the President's firmness in his opposition to new taxes.

Mr. MATSUI. Well, let us see after the 17th when Gramm-Rudman is perfected.

Mr. PICKLE. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Mr. Ross, we are grateful for your testimony, and I think you have stated faithfully what the position of the administration is as you know it.

There seems to be some considerable frustration of some of my colleagues out there who cannot understand why the President does not warmly embrace new taxes. However, those of us on this side of the bank up here do support that. I think it will be very interesting to find out what the vote will be on a tax bill to raise taxes of the American people. I think it may be quite different than the budget vote that was suggested here just a moment ago.

I notice that previous questioners wanted to know who has got the ball. My judgment is that Congress has the ball. Is that your judgment?

Mr. Ross. I think that certainly is the President's judgment.

Mr. FRENZEL. I have noticed some squirming by the congressional majority about traveling without the President. They did not squirm when they declared his budget dead on arrival. They did not need his help then, but they sure need his help now. For me, I am willing to let them squirm, and I thank you for your testimony.

Mr. PICKLE. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Ross, throughout your statement and in response to other questioners, you indicated that the President, the administration are opposed to new taxes. It seemed to me like you were stressing

the word "new" taxes. Does that rule out the possibility of increasing existing taxes?

Mr. Ross. Well, the President would view an increase in existing taxes as a new tax, so that would rule out that.

Mr. COYNE. So we have a definition of new taxes as an increase of existing taxes also.

Mr. Ross. Certainly an increase in income tax rates, or an increase in excise tax rates would be subject to the President's view of opposition to new taxes, yes.

Mr. COYNE. In the Congress and, to some extent, in the general public, I sense a sentiment that a value added tax may not be as onerous as originally thought and as it was discussed in earlier times. Are we to include any proposal that would be in the nature of a value added tax as something that the administration would be opposed to at this time?

Mr. Ross. Yes. His opposition would extend to that.

Mr. COYNE. And so an item that could potentially raise as much as $40 billion a year in revenue to address the budget deficit problem, the administration would look adversely at that also?

Mr. Ross. Yes.

Mr. COYNE. And so then I assume that if we are not to have any new sources of revenue or increasing existing sources, I would like to know what the feeling of the administration, and the Treasury Department particularly, is relative to the outcome of that. That is just to be added to the national deficit?

Mr. Ross. Well, the President's budget, which he continues to stand behind, had its own approach which I think achieved the same targets as the approach reflected in the budget reconciliation resolution. The President himself has supported, as I described very briefly in my testimony, certain revenue initiatives which he would not regard as new taxes and which I think cannot fairly be characterized as new taxes. But they would enhance revenue; for example, increased funding for certain activities of the IRS which would improve the collection of existing taxes already owed and due but simply not paid for whatever reason.

But the President's approach to the problem of the deficit I think is faithfully outlined in the budget he submitted to the Congress.

Mr. COYNE. But even with those initiatives, the 1988 budget would not be in balance.

Mr. Ross. It would not be in balance, but I believe it would have met the Gramm-Rudman target for 1988, at least on the assumptions which OMB provided for analyzing the budget.

Mr. COYNE. And so it is satisfactory in your estimation and in the President's belief that that is fine and OK.

Mr. Ross. Yes, the President certainly to my knowledge remains firmly behind his own budget proposal and believes that that was the appropriate response to the problem of the deficit.

Mr. COYNE. Thank you very much.

Mr. PICKLE. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Ross, I notice that you suggested applying a tax to State and local employees in the way of extending the Medicare hospital insurance coverage. I was not on the committee at the time nor involved in the negotiations, but my understanding had been that

the current state of law is the product of a compromise, between the two sides, that applied coverage to all new employees but did not go retroactively.

Is that a correct assumption? Is that a fair way to describe how we got to the current point?

Mr. Ross. Yes. I think, Mr. Brown, that is an accurate characterization. The President makes this recommendation I think based principally on the fact that most of the employees who currently are not covered are, in fact, receiving the benefits which the tax goes to support. I think it is a feeling that that is simply inappropriate, that a simple matter of fairness requires that they pay to support a program from which they benefit.

They do not get coverage directly from their own employment, but either because of spousal employment or employment outside of the State and local government, a very high percentage of these employees, in fact, receive the Medicare benefits.

Mr. BROWN. Have you looked at other alternatives other than applying this tax to prior employment for people who are employed prior to that cutoff date?

Mr. Ross. I am not myself sure what other alternatives there would be. I mean, I suppose you could try and raise the same amount from—well, I am not sure. It would seem to me any other approach, which I guess would necessarily involve raising the rates on other employees, would simply exacerbate that imbalance. You would still have people who are receiving benefits and not paying the tax.

Mr. BROWN. I am wondering how quickly these employees turn over. How significant is it that everybody coming on the payroll now is under this tax? Do they turn over every 3 years, 5 years, or what?

Mr. Ross. That is a good question. I do not know how quickly you would reach a point where effectively most, if not all, State and local—certainly at some point all State and local employees would be subject to the tax. I do not know how many years you have to go out before you reach that point.

I think the current exclusion, though, for employees hired before April 1, 1986, remains significant.

Mr. BROWN. I wonder if the folks at your shop could share with us any information they have there.

Mr. Ross. Sure.

Mr. BROWN. I do not know about when everybody gets covered, but at least some general figures as to how often they turn over or how significant the pickup in coverage will be because of change in employment.

[The information follows:]

TURNOVER RATE OF STATE AND LOCAL EMPLOYEES

In making revenue estimates, the Treasury Department has assumed an annual turnover rate among state and local employees of approximately three percent. This assumption is based on recent surveys of turnover among state and local employees. Under current law, coverage of state and local employees is expected to grow from 19 percent in FY 1988 to 39 percent in FY 1992, reaching full coverage by 2018.

Mr. BROWN. Also, I notice that you propose doing away with the windfall profit tax and estimate no revenue impact from that. Is

there a savings on the Federal level simply by not having that law on the book?

Mr. Ross. I think there is some savings simply in not having to administer the tax. I do not think it is terribly significant, but I think there is some savings.

Mr. BROWN. Are the reports required now even though oil prices are not——

Mr. Ross. Well, there certainly is a requirement that you keep track of your potential liability. I do not know if, in fact, you are required to report when you determine yourself you have no liability.

I can get back to you on that. I simply do not know.

Mr. BROWN. If you have anything in that area that would shed light for the committee, I would appreciate seeing it.

Mr. Ross. Sure.

[The information follows:]

COST OF ADMINISTERING WINDFALL PROFIT TAX

In FY 1986, the Internal Revenue Service expended 356 average positions (job assignments) and $15.3 million to process, examine, and litigate returns and issues generated by the Crude Oil Windfall Profit Tax Act of 1980. During FY 1987, an estimated 355 average positions and $14.9 million was spent on this effort. Workload performed by the Service in FY 1986 included processing data from the 10,506 tax returns (Schedules 6047 and 6248, Form 720) examining 5,863 returns which resulted in $977 million in recommended additional tax and penalties, and resolving tax disputes. As of September 30, 1986, there were 3,715 windfall profit tax cases in the process of examination.

[Dollars in Millions]

	Fiscal year 1986		Fiscal year 1987	
	Average positions	Amount	Average positions	Amount
Returns processing	90	$1.8	93	$1.8
Examination	244	12.7	240	12.2
Chief counsel	22	0.8	22	0.9
Total	356	15.3	355	14.9

Mr. BROWN. I yield back, Mr. Chairman. Thank you.

Mr. PICKLE. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman.

Just a few questions. I want to be sure that I appreciate the administration's position. His budget was—as you have already testified—voted on in the House and the Senate, and it received less than 30 votes in the House. I guess my question is: Do you really believe that the administration's budget is still material to this debate?

I continue to hear you and Howard Baker on Sunday on television state that the President's budget is a good budget. Regardless of the merits of the administration's budget, is it material to this debate? We have already voted it down resoundingly. Members of your own party rejected the budget. Do you intend to offer that budget again for a subsequent vote?

Mr. Ross. Mr. Andrews, I do not know the answer to that latter question, but it certainly seems to me the President's budget remains material to the debate. The determination of the budget is a collaborative process in which the President has an important role. So the fact that Congress has initially rejected his budget I do not think ends the matter.

Again, I have no ability to predict how the budget process will eventually resolve itself, but from everything I know, the President remains firm in his support for the budget and I think even more clearly in his opposition to new taxes.

Again, it seems to me that his proposal remains material simply because he himself remains very material to the process.

Mr. ANDREWS. One spending program that is important to me is the space program. The space station this morning was announced to maybe cost twice what we had originally thought.

Where do we find the revenues to pay for a new spending program like the space station without some source of new revenue enhancement? How do we do it without taxes?

Mr. Ross. I do not know the details of that issue. For me really to comment would be more or less simply my hypothetical speculation. To the extent Congress determines, though, that there are new items, new matters, programs that we ought to be spending money on, I suspect the judgment of the President would be that that would require some adjustment of priorities.

I think his strongly held general view is that Government is spending quite enough now and does not support additional spending. And to the extent that requires new programs to be funded, some adjustment in other programs, I would think that would be his response. But, again, I am not especially informed on that issue.

Mr. ANDREWS. The President over the weekend once again announced his call for a balanced budget amendment.

Mr. Ross. Yes.

Mr. ANDREWS. Some of us agree that a balanced budget amendment may well be a good idea. Do you and does the Treasury Department really think that is material to the debate of what we do this summer, next fall and next spring about these growing budget deficits?

Surely, the administration and the Treasury must recognize that should we vote a balanced budget amendment tomorrow it would not become effective at the earliest until some time in the next administration. What does that answer do about our immediate problem of what to do about these budget deficits and this budget that confronts us today?

Mr. Ross. Well, Mr. Andrews, you are no doubt right that it would not be a direct response to the immediate problem, though I suppose it would—at least in a symbolic way—suggest some commitment to solving the problem. That, I think, is an important first step, an expression of resolution, really, to address the problem.

But I certainly agree with you; the balanced budget amendment itself would not impact on this process in a direct or mechanical way. But that I think is not to say that the issue is not important now. Indeed, there is going to be a lag in its implementation whenever that process is completed.

So I do not really think that is an argument against starting that process, the fact that it is going to take a number of years before it is completed.

Mr. ANDREWS. I yield back my time, Mr. Chairman.

Mr. PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman. I will be brief, but let me follow up on a couple of questions Mr. Andrews raised.

You do not believe, apparently, that the solution to the fiscal problems we have today would be the development of a constitutional prohibition against deficit spending. Today's deficit problems have to be dealt with with some combination of fiscal restraint or additional revenues, spending restraint or revenue. Is that correct?

Mr. Ross. Yes. I mean, certainly the balanced budget amendment would not affect fiscal year 1988.

Mr. DORGAN. Yet the President seems to be spending most of his time moving around the country suggesting that the solution here really is a constitutional amendment to balance the budget. Is that not his basic position on fiscal policy issues these days?

Mr. Ross. Well, I do not know that he was—certainly it would not be the function of a President simply to look at fiscal year 1988. I think he is addressing the deficit problem in general terms, and I think on that he certainly is on sound ground in suggesting the balanced budget amendment would be a long-term solution.

Mr. DORGAN. Mr. Ross, let me just say as one Member of Congress, as a member of a group here that is struggling in a very serious and sober way to try and put together a response to what we think are very serious fiscal policy problems, I find it completely disingenuous of President Reagan to disengage himself from Government in fiscal policy. That is exactly what he has done, being as ridiculous as he is being, in suggesting that the constitutional amendment to balance the budget to prevent him from behaving as he has behaved the past seven years somehow will solve our fiscal policy dilemma. Now, he has every right to make whatever speech he wants, to go where he wants, to do what he wants, but doing that in my judgment abdicates responsibility.

The President has sent seven budgets to Congress. Seven of them. Never has he proposed a balanced budget. Not only has he not proposed a balanced budget, he has proposed $930 billion in deficit. It is almost $1 trillion.

Now, he is suggesting that somehow that behavior is because the constitution did not prevent him from submitting budgets that were out of balance. I find that so disingenuous it is hard for me to describe it. To do that without some sort of mischievous grin about how he is trying to fool people almost persuades me to nominate him for an Oscar.

It is disappointing at best. We have a responsibility to impose spending restraints and revenues to put this thing in order, and I sure wish the President would join us in a constructive, responsible debate about that. I am convinced, frankly, that if the President were Bob Dole or the President were Howard Baker or someone on the Democratic side, we would be having a serious discussion about expenditures and revenues to try and resolve a very serious problem.

I just wanted to say to you, and I hope you will take it back, that I for one am very, very disappointed in this President. He knows better than that. He knows better than what he is doing the last few weeks. It is not public policy; it is show biz.

Mr. Ross. Mr. Dorgan, I——

Mr. DORGAN. Those of us who are involved in a serious construction of trying to deal with fiscal policy resent it.

Mr. Ross. Mr. Dorgan, I will report your remarks, but it does seem to me the President is acting, indeed, quite responsibly. He is addressing the budget problem in a broad sense with his proposals on a balanced budget amendment, and he has, in fact, submitted a budget to the Congress that met the Gramm-Rudman targets for fiscal year 1988.

Indeed, I think in terms of the history of the last seven years—I am not an expert on the budget process, but I would be surprised to learn that the budgets that the President has gotten back from Congress have ever been more conservative than the one that the President has submitted to Congress. I do not think it is accurate to suggest that it is Congress that is trying to hold the line on spending and that the President has, in fact, not cooperated in that process. But, again, I am not an expert in the process.

Mr. DORGAN. Let me be the first to say that Congress is not without responsibility here and not without its faults, but let me also be clear that the President has responsibilities for leadership. To simply send us giant deficits in his budgets and then point fingers and say, "Your problem, Congress, is that you followed my leadership, and the reason I was persuaded to lead that way is because there is no constitutional barrier preventing me from proposing budget deficits"—I think is irresponsible.

I would hope to get back to a point in time where the President and Congress, Republicans and Democrats would work together in a very sober, serious way to address what I think are serious problems.

Now, again, let me be clear. I do not mean this as Democratic or Republican rhetoric. I mean it in the manner that suggests I think the President is unfair to Congress and I think he is unfair to the American people when he goes about and does what he has done the last couple of weeks.

Mr. PICKLE. Mr. Moody.

Mr. MOODY. Thank you.

I would like to associate myself with the comments and observations of my two colleagues, Mr. Andrews and Mr. Dorgan. Did I hear you say that the administration requested smaller deficits that Congress has, in fact, voted out?

Mr. Ross. I am not sure the issue is deficits that I meant to address rather than spending, but, again, I am not really an expert on the budget process.

Mr. MOODY. Well, that is factually incorrect. I heard you say that. In fact, Congress has typically voted smaller deficits in most years than the President asked for.

Mr. Ross. Do you mean deficits or——

Mr. MOODY. Deficits. We are talking about deficits.

Mr. Ross. Well, I mean, you could, I suppose, address the deficit by tax increases, and the President's opposition to that, I think, is clear.

I do not think that the——

Mr. MOODY. Well, I just want to correct your statement that the President asked for smaller deficits than we have given him. We have given him, typically, with one or two exceptions, smaller deficits than he has actually asked for. I just want to get the record straight.

Let me turn now to the question about the balanced budget amendment. When do you think a balanced budget amendment would take hold, supposing we were to act expeditiously?

Mr. Ross. Well, Mr. Moody, I really do not know. I mean, the process of ratifying an amendment is unpredictable at best.

Mr. MOODY. No, but assuming the path went smoothly and went well, what is the soonest? I have heard an estimate of 6 years. Do you have an estimate on that, a comment on that?

Mr. Ross. I really do not. I really do not. That is something that——

Mr. MOODY. Has anyone at Treasury analyzed the time lag required for bringing a balanced budget amendment into being?

Mr. Ross. It has not been in my office. I suspect people have taken a look at that.

Mr. MOODY. Would you let us know what that is.

Mr. Ross. Certainly.

Mr. MOODY. Because my understanding is it would be 6 years, and to pretend to the American public that we can go for 6 years waiting for the remedy to take place—if, in fact, that is a viable remedy—is extremely misleading.

Mr. Ross. Well, but I do not think it is accurate to suggest that that is all the President is doing on this issue. I think he is providing leadership on the question of how you address the long-term problem. Certainly, that is not the only thing the President is engaged in.

Mr. MOODY. Would you let us know how long-term that is before his proposal, that he is going around the country talking about, would actually take place.

Mr. Ross. Certainly.

[The information follows:]

We do not have any additional information at this time to add regarding the anticipated timetable for enacting a balanced budget Constitutional amendment.

Mr. MOODY. Thank you.

Is the Treasury officially in support of a balanced budget amendment?

Mr. Ross. I do not know that the Secretary has stated a position, but certainly it is the administration's position. I would be startled to hear that the Secretary of the Treasury was not fully in accord with it.

Mr. MOODY. Have you yourself been involved in any analysis of the consequences on revenue spending and fiscal stabilization of a balanced budget amendment?

Mr. Ross. I have not.

Mr. MOODY. Well, perhaps you are not prepared to answer this question, then. But if it is the official position of the administration that a balanced budget amendment is needed to solve the deficit problem, I hope you would be able to comment on the question of what you do in a recession when you have to either start raising taxes or cutting spending, both of which would have the effect of worsening the recession. And, of course, in a real depression, you would have to raise taxes even higher and cut spending even harder, which would again be procyclical, would accentuate the business cycle rather than dampen it.

Have you concentrated on that? It is a key policy issue.

Mr. ROSS. Again, I have not. My office has not, and I would suspect there are others in Treasury who have. Perhaps there is something we could submit to you that would reflect that.

Mr. MOODY. I would be most interested to know how would you replace the fiscal stabilizers that are inherent in letting the budget run not in perfect balance when you have a business cycle that takes place because in a recession you would have to raise taxes, making the business cycle deeper. In a depression you would have to raise them really high, and you would drive yourself deeper and probably enlarge the deficit rather than diminish it.

Mr. ROSS. Yes. I understand the question. All I can say at the moment is I will try and get back to you to the extent there is in-house analysis at Treasury.

Mr. MOODY. Did I hear you say to Mr. Dorgan that the President has submitted a budget that met the Gramm-Rudman target?

Mr. ROSS. For fiscal year 1988.

Mr. MOODY. You seriously believe that it did?

Mr. ROSS. Yes, I guess I do. Yes.

Mr. MOODY. You are not aware of the CBO analysis?

Mr. ROSS. Well, not based on CBO assumptions, but on OMB assumptions it did meet that target.

Mr. MOODY. Does Treasury continue to believe that their $32 billion shortfall in meeting Gramm-Rudman has vanished? Do you believe that the President's budget has seriously met Gramm-Rudman in light of subsequent analysis?

Mr. ROSS. I do not know of any analysis, subsequent analysis that has changed—again, taking OMB assumptions—the conclusion that the President's budget met the Gramm-Rudman targets.

Mr. MOODY. Does Treasury continue to believe that those assumptions are realistic?

Mr. ROSS. To the best of my knowledge, they do. Now, there is a midsession review going on, and perhaps that will change. I do not really know. But to the best of my knowledge, there has been no——

Mr. MOODY. How big an analytic arm do you have at Treasury to look at these things, and do you do your own independent analysis?

Mr. ROSS. The OMB assumptions are done by OMB and not at Treasury.

Mr. MOODY. Right. Does Treasury do some?

Mr. ROSS. I do not know if that is a companion or collegial process or not. It is something I can find out.

Mr. MOODY. Would you let us know?

Mr. ROSS. Sure.

[The question was not answered.]

Mr. DORGAN. Would the gentleman yield?

Mr. MOODY. Certainly.

Mr. DORGAN. I have heard that answer, and the only reason I did not follow up on it at the time about meeting Gramm-Rudman projections for this year is that I did not think anyone in the free world still believed that to be the case. I think almost everyone understands that that was missed by $30 billion at least.

Mr. ROSS. That is off of CBO assumptions, and the President's budget is necessarily prepared on OMB assumptions.

Mr. DORGAN. Well, that is exactly the point. I do not think anyone in the free world still believes that that budget met the Gramm-Rudman targets.

Mr. MOODY. You talked about the opposition of the President to taxes. Are there any general revenue taxes in the President's proposal?

Mr. ROSS. None that I am aware of, no.

Mr. MOODY. What about the tax on coal, excise tax on coal, $1.70——

Mr. ROSS. Well, that is to fund a trust fund that is currently insolvent.

Mr. MOODY. Is that strictly for the trust fund funding?

Mr. ROSS. Yes. It would be dedicated revenues.

Mr. MOODY. It is not clear from your statement whether or not that goes purely into the trust fund or into a general revenue because other parts of your statement indicate that the black lung has to be merged, to some extent, with the general revenues.

Mr. ROSS. I am not sure what——

Mr. MOODY. Perhaps you could elaborate later.

Finally, the user fees the President initially proposed, how much in user fees and how much in asset sales? Just put the record straight on the receipts.

Mr. ROSS. The asset sales, I believe, were in the area of $13 to $14 billion for fiscal year 1988. User fees, I am not sure exactly how that would break down. The total of the revenue initiatives I discussed in my testimony was $6.1 billion. That includes money I think that could not be characterized as user fees. The IRS initiative is a substantial source of revenue, and there are some others that perhaps would not be characterized as user fees. The black lung fund, I do not know if you would characterize that as a user fee or not.

Mr. MOODY. Okay. Thank you.

Mr. PICKLE. Mr. Flippo.

Mr. FLIPPO. No questions.

Mr. PICKLE. Mr. Levin.

Mr. LEVIN. Just a brief one. I missed some of the earlier testimony. Let me just be clear about your terms of reference.

Are any of these proposals tax increases?

Mr. ROSS. We would say they are not, no.

Mr. LEVIN. None.

Mr. ROSS. Well, one can engage in what is I think largely a semantic debate about what is or is not a tax. They all have the character, I think, as initially described, as either supporting the collection of existing taxes that are not currently paid, going to bring

solvency to certain existing trust funds, or providing user fees or eliminating exemptions from current user fees where the tax—if it is so characterized—is paid in exchange for a direct governmental service or benefit.

Mr. LEVIN. Well, the FICA proposals, are they not tax increases?

Mr. Ross. Well, again——

Mr. LEVIN. I mean for the common person, the typical person who is going to pay that, is that not a tax increase?

Mr. Ross. He will pay more money in taxes. I think there is no question of that.

Mr. LEVIN. That is a tax increase, is it not?

Mr. Ross. Again, that gets into what I think is largely a semantic and, in some sense, unimportant issue. I think the point on the FICA increases is that those are people who currently draw Social Security benefits, and yet do not pay as much as others pay to draw the same benefits. So we would certainly view that as simply reforming an existing tax base.

There are people again who are getting Social Security and not paying their fair share for it.

Mr. LEVIN. Let me just say you say it is semantics, but earlier you say any increase in taxes should be viewed as a breach. I just think you ought to understand how you are engaging in semantics when you talk that way.

Mr. Ross. Well, I do not intend to. I think there is a substantive distinction between general tax increases and an adjustment in the rules on what is covered employment for FICA purposes that brings——

Mr. LEVIN. You say the word "general." So what you really mean to say is any increase in general taxes should be viewed as a breach of the pact. That is what you really mean to say, right?

Mr. Ross. Again, I think the word "general" will probably be subject to the same sort of issues. But that perhaps is a more precise characterization.

Mr. LEVIN. That is your meaning? When you say that, you really mean general taxes or taxes in general, right?

Mr. Ross. Yes, I think it is difficult to pin this issue on any particular word and how that word is defined and whether that word is "tax" or "general" or whatever. I do think there is a substantive and important distinction between, for example, the FICA proposals and to take, I suppose, the clearest cases in the opposite direction, an increase in income tax rates.

Mr. LEVIN. I think we would all agree with you. It is just when you do not use any modifiers and just say any increase in taxes, I would consider that not semantics but demagoguery.

Mr. Ross. Well, I would certainly quarrel with the demagoguery, but, again, you could come up with a more precise formulation than no new tax. I do not disagree with you on that.

Mr. LEVIN. Good. Convey that to the people up the ladder, would you?

Mr. BROWN. Would the gentleman yield?

Mr. LEVIN. Yes.

Mr. BROWN. Just for clarification, I am not sure all of you understand this. When Democrats propose tax increases they are tax in-

creases, and when Republicans propose them ours are revenue enhancement. I wish you could get that straight. [Laughter.]

Mr. LEVIN. Thank you. No, we have it straight. It is your leader who does not have it straight.

Thank you, Mr. Chairman.

Mr. PICKLE. Thank you.

Mr. Ross, we thank you for your testimony. Before you leave, let me just ask you: Staff has put out a pamphlet of 300 pages with recommendations of closing loopholes and/or raising revenues in different areas. Have you taken a position on any place where we could close loopholes? Would you support that? Would Treasury support that?

Mr. ROSS. Again, Mr. Chairman, my answer has to be no. The only caveat I would note again is the MLP proposal which is under review by the administration.

Mr. PICKLE. Which one?

Mr. ROSS. The MLP proposal.

Mr. PICKLE. Well, now, in the tax bill that we passed last year, in the ESOP section, we gave partial relief from estate taxes, and it was estimated at the time we would lose probably about $300 million. Now, it looks like over a 5-year period we would lose closer to $20 billion. Both IRS and Treasury unilaterally say that ought to be cut back to around $7 billion.

There is a question of whether Treasury unilaterally has the authority to do that. But that is not in your testimony at all. I notice the chairman of our committee, Mr. Rostenkowski, and the chairman of the Finance Committee, Senator Bentsen, have recommended that we cut that provision back so that it would lose as originally intended the sum of around $300 million.

What is the Treasury position on the ESOP estate matter? Are you for it or are you against it?

Mr. ROSS. Mr. Chairman, we would support that. That, I believe, is currently a part of the technical corrections bill introduced by Chairman Rostenkowski.

Mr. PICKLE. No, it is not in that. I am advised it is not.

Mr. ROSS. Someone has just suggested to me there may be a separate bill. But in any event, we would support that to bring the provision in line with what was intended in the tax reform process.

Mr. PICKLE. To $300 million? All right. I understand you now.

In this pamphlet, there is one recommendation that we should cut the capital gains tax rate down to 15 percent, a rather sizable reduction from the 28 percent level. It has been estimated by some that if you did that it would raise approximately $15 billion in new revenue.

Does Treasury agree with that sum?

Mr. ROSS. Mr. Chairman, I do not know that we have an exact figure, but we certainly would not project a revenue pickup from a reduction in the rate to 15 percent. People who support that I think make the general argument that by reducing the capital gain rate you encourage people to sell their assets, realize their gains and pay taxes.

One reason that a reduction in the rate now would not likely in the short-term have that effect is that the effective increase in the capital gain rate in the Tax Reform Act encouraged many people

at the end of 1986 to sell assets that had accrued gains and to realize those gains and pay taxes. Some, in fact, suggested that was the reason that Treasury tax receipts were increased in the first half of 1987.

In any event, many accrued gains were already realized in 1986; reducing the rate now would, thus, not have the effect it might have in the long term in inducing additional realizations which would offset the loss caused by reducing the rate of tax on those sales that occurred.

Mr. PICKLE. Well, it is Treasury's position that you do not recommend lowering the capital gain tax rate?

Mr. ROSS. It would be a revenue loss, yes.

Mr. PICKLE. From 28 percent to any lower amount? At 15 percent you said yes, it would be a loss, but is there anything in between?

Mr. ROSS. I think our own analysis probably was based on a 20 percent rate rather than 15 percent, but 15 percent——

Mr. PICKLE. Even at 20 percent you would not be for that?

Mr. ROSS. Even at 20 percent, I believe there would be at least a short-term revenue loss, yes. And short term would probably continue for the budget period.

Mr. PICKLE. We are going to have testimony on this later, but Treasury would oppose lowering the capital gains rate? Is that your position?

Mr. ROSS. Certainly viewed in isolation, yes.

Mr. PICKLE. Well, we thank you very much for your testimony. We appreciate you coming here this morning.

Mr. ROSS. Thank you, Mr. Chairman.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY
WASHINGTON

COMMITTEE ON WAYS AND MEANS
RECEIVED
JUL 14 1987

July 10, 1987

Dear Mr. Chairman:

I wish to clarify for the record the statement I made on July 7 at the hearing before the Committee on Ways and Means regarding the Administration's position on the reduction of the tax rate on capital gains.

As you recall, the Administration supported a reduction in the capital gains rate to 17.5 percent as an important feature of the capital recovery provisions of the President's tax proposals issued in May 1985. Although the increase in rate for long-term capital gains to 28 percent was not advocated by the Administration, and we were disappointed in this result, we nevertheless strongly support the Tax Reform Act of 1986 and do not believe that tax reform should be reopened by modifying the tax rate structure.

With regard to the revenue effects of a reduction in rates on long-term capital gains, we understand that to maintain consistency with CBO scoring for tax reform, the Congress' budget estimating process would attribute a revenue loss to such a proposal. Thus, given our understanding of this process, a proposed reduction of the long-term capital gain rate to 15 percent may not accomplish the purpose of raising revenue which its supporters intend, at least for purposes of satisfying the requirements in the budget resolution.

As you know, Treasury has issued a Report to the Congress on the Capital Gains Tax Reductions of 1978, which supports a somewhat different view of the relationship of the long-term capital gain rate and revenue than is reflected in the CBO scoring for tax reform. The study focused principally on the tax rates adopted in 1978, and many important changes have occurred since then. In particular, our study did not consider the impact of a reduction of the long-term capital gains rate in the context of the Tax Reform Act of 1986. One of the changes made in the Tax Reform Act, the increase in capital gain rates beginning in 1987, caused many investors to realize capital gains at the end of 1986. As I noted in my remarks, this may have diminished the stock of accrued capital gains that would be realized in response to a lower rate. There is, however, a body of research that indicates that a substantial reduction in the maximum capital gains rate could result in increased revenues over time.

Sincerely,

Dennis E. Ross
Tax Legislative Counsel

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Mr. PICKLE. Our first panel consists of Dr. Richard Rahn, Dr. Rudy Oswald, accompanied by Mr. McGlotten, and Mr. Paul Huard.

If you three individuals would come take your positions at the witness table.

The Chair would ask our guests if they are going to leave, please do so, and not congregate around the door. And if everyone would please take a seat. We have guests here this morning. There are seats out in the room and we would like for you to take a seat.

Our panel consists of Dr. Richard Rahn, vice president and chief economist for the United States Chamber of Commerce. Dr. Rahn.

Then we have the American Federation of Labor and the CIO, Dr. Rudy Oswald, director of the department of economic research. And I understand you are accompanied by Mr. Robert McGlotten. Is he not here this morning?

Dr. OSWALD. He is not here.

Mr. PICKLE. And then we have Mr. Paul Huard who represents the National Association of Manufacturers.

We'll start first, Dr. Rahn, with your statement.

We would remind you again, doctor, that we will ask you to summarize your testimony in 5 minutes, so that we might proceed to the questioning period.

Dr. Rahn.

STATEMENT OF RICHARD W. RAHN, PH.D., VICE PRESIDENT AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

Mr. RAHN. I am Richard Rahn, vice president and chief economist of the United States Chamber of Commerce.

Mr. Chairman, on behalf of our 180,000 member businesses, associations, and State and local chambers of commerce, I welcome the opportunity to present our thoughts on the difficult choices you must make this year.

Discussion of tax increases has to date proceeded in a disturbing manner. We find ourselves debating tax increases on their progressivity, their acceptability, and even their disguiseability. Lacking from this debate has been any meaningful discussion over what makes good tax policy. The fundamental question, "Will Americans be better or worse off given a $20 billion tax increase" seems to be rarely asked. Our analysis gives an unambiguous "worse off" answer to this question.

Truly bizarre arguments have been made as to why Congress cannot cut spending and why it must increase taxes. Setting aside specific special interest pleading and ideology, let's look at the facts.

One, every time Congress has increased taxes since World War II, spending has increased an average of $1.58 for every $1 increase in taxes. As a result, deficits have tended to grow larger rather than smaller after tax increases.

Mr. MATSUI. Mr. Chairman, may I interrupt for a minute for a point of order?

Mr. PICKLE. Sure. Mr. Matsui.

Mr. MATSUI. I do not want to cut off Mr. Rahn because I think he raises some important points. But I wonder if that is a better dis-

cussion for the Budget Committee rather than for this tax writing committee, since our mandate is to implement the Budget Committee's recommendation of $19.3 billion worth of revenues. If you have options available, I would like to hear those because that is our mandate.

I tend to agree with you that unless the President cooperates, we really should not be talking about raising revenues, but we are stuck with it. The budget resolution is law, or at least among the House and Senate Members. And so we ought to find out what the U.S. Chamber's position is on the available options.

Do you support the administration's package as outlined by Mr. Ross this morning, or do you have objections to any of the proposals?

Mr. PICKLE. Mr. Matsui, I appreciate your questioning. We recognize the witness for the 5-minute period and this will not come out of your time.

I assume you will address some of the questions Mr. Matsui raised.

Mr. RAHN. Yes. I will point out $20 billion or more in economically constructive revenue raising options under this committee's jurisdiction.

An increase in tax rates on labor, capital, or directly on goods and services tends to raise less revenue than initially forecast because the tax increases the cost of whatever is being taxed, resulting in a decline in the demand for the item being taxed.

Third, tax increases, by increasing the cost of whatever is being taxed, result in a less than optimum allocation of resources which, in turn, lowers real incomes, reduces job opportunities, and raises economic misery. Taxes alter the return to every activity undertaken by individuals and businesses, thus altering the allocation of resources in the economy away from the most efficient uses as determined by individual decisions in the market.

Fourth, tax increases facilitate increases in Government spending. Beyond a certain percentage of gross national product, increases in Government spending reduce rather than enhance economic growth. The United States has already passed that point, and further increases in spending will reduce economic growth. The reduced growth rate occurs for three reasons: the increased cost of tax administration and compliance, the Government sector tends to be less efficient than the private sector, and Government transfer payment programs tend to misallocate resources and provide disincentives for productive economic activity. As in the case of tax increases, this reduced rate of economic growth results in few job opportunities, less progress against poverty, and more economic misery.

I shall now list a number of economically constructive revenue raising options that this committee has the jurisdiction to address in addition to other economically constructive revenue raising options that are not directly in this committee's jurisdiction, but with a change in the jurisdiction rules can be addressed by this committee.

The Gramm-Rudman-Hollings Act allows a committee of the House or Senate that receives a budget reconciliation directive to substitute spending reductions equal of up to 20 percent of the rev-

enue increases required by the directive. In accordance with this provision, we recommend that the committee substitute $3.9 billion in spending reductions for revenue increases.

In addition, we recommend the following revenue raising options for your consideration.

First a reduction in the capital gains tax rate to 15 percent. Despite the comments of the previous witness from Treasury, the empirical evidence is overwhelming that a reduction in the capital gains tax rate from 28 to 15 percent would increase capital gains tax revenues by between $3.5 and $8 billion in 1988, and between $5 and $11 billion in 1989.

I can remember back in 1978 when we had this debate on reducing the capital gains tax rate a number of folks, including the Treasury and others, claimed that we would have a big revenue loss. I had predicted that we might gain up to $1 billion in additional revenue. The result was a $2.6 billion revenue gain in the first year. I greatly underestimated the amount of revenue raised as a result of the 1978 capital gains rate reduction.

Again we saw revenue increase with a reduction in the capital gains rate in 1981. You are going to hear from many different economists and groups about whether or not a reduction in the capital gains tax rate raises or loses revenue. If you look at the track record of those people who have been predicting the revenue impact of a reduction in the capital gains rate over the last 20 years. I think the economist by far and away who has the best record is Dr. Martin Feldstein of Harvard University, who is also president of the National Bureau of Economic Research. I suggest when you look at the empirical evidence, you also look at the predictive record of the people who will testify before you. I am willing to bet that most of those folks who tell you a 15 percent capital gains rate will result in a revenue loss are the same people who were wrong in 1978 and 1981. They will be wrong again if they are predicting a revenue loss from a 15-percent capital gains rate.

Another benefit of reducing the capital gains tax rate is that the reduction makes the tax system more progressive by increasing the tax revenue received from the upper income groups, as was shown by the 1978 and 1981 capital gains rate reductions. Better allocation of investment resources reduces the locking in effect, which results in higher levels of investment, in turn, creating more jobs and higher income levels.

There are a number of other economically constructive things that your committee can do to raise revenue. One suggestion, which has been made by a number of Members of Congress that we suggest you examine is Tax Court docket relief. The proposals have been to allow taxpayers to settle their disputes with the IRS for some fixed percentage of the amount in dispute, plus interest. Such an approach would have the quadruple benefit of aiding the administration of the civil justice system, enhancing Federal revenues during a period when revenues are badly needed, reducing Tax Court administrative expenses, and freeing IRS personnel for other enforcement purposes.

Some have estimated that this proposal could raise billions of dollars. We believe that at least $1 billion could be raised from this proposal.

Another revenue raising option is the sale of the Naval Petroleum Reserves. This would raise $2.5 billion in annual receipts. There are also many Federal financial assets that could be sold. The administration has proposed many assets that could be sold by the Government. Realistically, we believe you could raise between $5 and $10 billion on the sale of such financial assets.

Charging user fees on inland waterway projects would raise a billion dollars. User fees for Federal credit programs, according to OMB estimates, would raise revenues of $1.5 billion in the first year. Coast Guard user fees could generate $900 million annually.

A proposal to option the unassigned broadcast spectrum could raise $600 million annually. The sale of excess Federal real property could raise many billions of dollars, depending on how much the Government chooses to sell. The U.S. Government owns 33 percent of the land in the country, and even a modest land sale could easily bring in a billion dollars a year.

Another proposal within the jurisdiction of this committee would be to price-index Government bonds, or issue gold-backed bonds. We believe you could easily raise up to $12 billion a year in interest savings from this proposal.

Two other revenue raising proposals are the sale of Amtrak which probably could raise $1.6 billion and the sale of excess military bases. Congressman Armey has already introduced a bill and coauthored an article with Senator Goldwater on the sale of excess military bases. Their revenue estimate from the sale of excess military bases was, I believe, $2½ billion. We believe that even if you didn't raise that amount, you could easily raise $1½ billion annually from the sale of excess military bases.

The revenue raising options I have listed in my testimony would raise between $27 and $47 billion if all of the proposals were implemented. Each of these proposals would help to enable the Congress to meet its deficit reduction targets in an economically constructive manner without slowing economic growth, exacerbating poverty, increasing unemployment, or harming the competitiveness of U.S. business.

It is possible for you to make tax and spending adjustments that we believe will ensure a continuation of our near record peacetime expansion. We urge you to take the constructive course we have recommended rather than burden the economy with a major tax increase which is guaranteed to increase the misery of many of our citizens.

Thank you for the opportunity to present our views on the important issue of how best to raise the revenues necessary to meet the budget resolution requirements.

Thank you, Mr. Chairman.

[The statement of Mr. Rahn follows:]

STATEMENT
on
REVENUE INCREASES
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U. S. CHAMBER OF COMMERCE
by
Dr. Richard W. Rahn
July 7, 1987

I am Richard Rahn, Vice-President and Chief Economist of the United States Chamber of Commerce. On behalf of our 180,000 member businesses, associations and state and local chambers of commerce, I welcome the opportunity to present our thoughts on the difficult choices that you must make this year.

The recent budget resolution instructs the House Committee on Ways and Means and the Senate Committee on Finance to raise $19.3 billion in new revenues for Fiscal Year 1988 as part of an effort to substantially reduce the deficit. That is the unpleasant task with which your committee is faced. It requires the committee to make difficult choices that will have a lasting impact on the economic future of the country. The committee can meet the dictates of the budget resolution by agreeing to proposals that will be economically destructive, or it can adopt an economically constructive course that will reduce the federal budget deficit, promote prosperity and improve the standard of living of the American public.

The U.S. economy is today much healthier than it was in 1981. Unemployment, inflation and interest rates are all significantly lower. Yet the accomplishments of the last six years are not grounds for complacency, for the economy is weaker than we would all prefer. During the past two years, economic growth has averaged about 2.5 percent and projections for 1987 do not include an improvement over that rate. This lackluster performance can, in large part, be traced to the climate of uncertainty surrounding tax policy.

Discussion of tax increases has, to date, proceeded in a disturbing manner. We find ourselves debating tax increases on the merits of their progressivity, their acceptability, and even their disguiseability. Lacking from this debate has been any meaningful discussion over what makes good tax policy. In essence, good tax policy starts with a very simple question, "Does this provision belong in the tax code?" It does not, as has been all too often the case, start with "Can this be taxed?" The fundamental question -- "Will Americans be better or worse off given a twenty billion dollar tax increase?" -- seems to be rarely asked. Our analysis gives an unambiguous "worse off" answer to that question.

Truly bizarre arguments have been made as to why Congress cannot cut spending and why it must increase taxes. Setting aside specific special interest pleading and ideology, let's look at the facts:

1. Every time Congress has increased taxes since World War II, spending has increased an average of $1.58 for every $1.00 increase in taxes. As a result, deficits have tended to grow larger rather than smaller after each tax increase.

2. Increases in tax rates on labor, capital or directly on goods and services tend to raise less revenue than initially forecast because the tax increases the cost of whatever is being taxed, resulting in a decline in the demand for the item being taxed.

3. Tax increases, by increasing the cost of whatever is being taxed, result in a less than optimum allocation of resources, which, in turn, lowers real incomes, reduces job opportunities, and raises economic misery. Taxes alter the return to every activity undertaken by individuals and businesses, thus altering the allocation of resources in an economy away from their most efficient uses as determined by individual decisions in the market.

4. Tax increases, as shown in (1) above, facilitate increases in government spending. But, beyond a certain percentage of Gross National Product (GNP), increases in government spending reduce rather than enhance economic growth. The U.S. has already passed that point and further increases in spending will reduce growth. The reduced growth rate occurs for three reasons: the increased cost of tax administration and compliance, the government sector tends to be less efficient than the private sector, and government transfer payment programs tend to misallocate resources and provide disincentives for productive economic activity. As in the case of tax increases, this reduced rate of economic growth results in fewer job opportunities, less progress against poverty and more economic misery.

ECONOMICALLY CONSTRUCTIVE REVENUE RAISING OPTIONS

Section 310(c) of the Balanced Budget and Emergency Deficit Control Act of 1985 (P.L. 97-177; Gramm-Rudman-Hollings) allows a committee of the House or Senate that receives a budget reconciliation directive to substitute spending reductions equal of up to 20 percent of the revenue increases required by the directive. In accordance with this provision, we recommend that the committee substitute $3.9 billion in spending reductions for revenue increases. In particular, we recommend that the committee consider the price-indexed bond proposal described below or reduce entitlement spending within its jurisdiction.

In addition, we recommend the following revenue raising options for your consideration.

Capital Gains Taxation

The Tax Reform Act of 1986 marked a significant change in American tax policy. The Act recognized that high marginal tax rates served to hinder economic growth by reducing incentives to work, save and invest. Tax rates were lowered almost across the board, for both individuals and businesses. I say almost across the board because the Act failed to extend that principle to the treatment of capital gains. Rather than lower the capital gains rate, as was done for all other forms of income, that rate was raised from 20 to 28 percent, a 40 percent increase. If you consider state income taxes, the capital gains rate was in some cases increased by as much as 66 percent.

Capital gains have shown a strong sensitivity to tax rates. In the years 1969-1975, when capital gains were taxed at a rate of 42.5 percent, there was essentially no growth in capital gains realization. When the rate on capital gains was increased further in 1976 -- to 49 percent -- there was again little growth in capital gains notwithstanding the high rate of inflation. When rates on capital gains were finally reduced in 1979 the effect was not, as many had predicted, a revenue loss. Quite the contrary. Capital gains increased from $45.3 billion in 1977 to $73.4 billion in 1979. This increase in the amount of capital gains realized in 1979 translated into $2.6 billion of additional revenue despite the lower tax rate applied to those gains. In 1981 the rate on capital gains was reduced from 28 to 20 percent, and resulting in further federal revenue gains of more than $1 billion per year.

Dr. Lawrence Lindsey, of Harvard University and the National Bureau of Economic Research, has examined the relationship between tax rates and capital gains. His findings confirm the negative effect of high capital gains taxes on federal revenues and indicate that large revenue gains are possible from a reduction in the capital gains tax rate. Dr. Lindsey's re-estimation of Martin Feldstein's work, excerpted in Table I, led him to project a $7.7 billion increase in federal revenues for 1988 following a reduction in the capital gains rate to 15 percent. Over the period 1988-1991 this gain could amount to as much as $43.2 billion. Lindsey's own model predicts that reducing the rate to 15 percent would increase revenues by $19.2 billion.

TABLE I
POTENTIAL REVENUE EFFECT OF A
FIFTEEN PERCENT CAPITAL GAINS TAX
($ billions, fiscal years)

Revenue	1988	1989	1990	1991	Total
Feldstein	7.73	10.99	11.80	12.73	43.2
Lindsey	3.49	4.92	5.25	5.57	19.2

Source: Lawrence Lindsey, Capital Gains Taxes under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions (Cambridge, Massachusetts: National Bureau of Economic Research, 1987)

Increases in capital gains realization would come primarily from the affluent. In other words, reducing the capital gains rate would increase the progressivity of the tax system by increasing the share of the overall tax burden borne by upper income taxpayers. The experience of 1981-1985 shows how dramatic this effect can be. As Table II shows, time periods with lower capital gains rates have been associated with increases in capital gains by each and every income group. All income classes increased their realization of capital gains, although upper income groups increased their capital gains, and therefore their taxes, by a larger amount than lower income groups.

An increase in capital gains realization allows individuals to adjust their portfolio holdings. At a lower rate, individuals are no longer "locked in" to existing investments because they would not lose as high a percentage of their equity to the government. The ability to engage in portfolio adjustment is an integral part of a free market economy and will enhance efficiency and promote economic growth. Moreover, these individuals will be more willing to invest in entrepreneurial ventures once the tax on success is smaller.

Clearly, a reduction in the capital gains tax rate will have the benefit of providing at least $3.5 billion in additional revenue for the government. Moreover, it will increase capital formation and venture capital, which in turn will create more jobs and income for our citizens.

TABLE II
NET LONG-TERM CAPITAL GAINS 1978-1984

AGI Class ($000)	%Change 1978-1981	% Change 1981-1984
0-25	36.1%	78.8%
25-50	13.3	53.9
50-100	69.7	88.4
100-500	120.9	76.8
500 and above	302.7	169.1

Source: Statistics of Income, Internal Revenue Service, 1978-1984.

Tax Court Docket Relief

As of March, 1987, the Tax Court had an enormous backlog of 79,300 cases. A single case can take as many as 10 years before it is heard. The effect of this backlog is twofold. It is unjust to the taxpayer and it deprives the federal government of revenues for years. It is also unfair that taxpayers must wait years to have their disputes with the Internal Revenue Service (IRS) resolved, because the potential penalties and interest compound and uncertainty continues. Speedy resolution of disputes is a central notion of American justice. Moreover, the federal government is deferring billions in revenues by allowing the backlog to become so serious.

Several members of Congress have suggested that the government allow taxpayers to settle their disputes with the IRS for a fixed percentage of the amount in dispute, plus interest. Such an approach would have the quadruple benefit of aiding the administration of the civil justice system, enhancing federal tax revenues during a period when revenues are badly needed, reducing Tax Court administrative expenses, and freeing I.R.S. personnel for other enforcement purposes. This revenue raising option could, based on the number of outstanding cases and average awards, conceivably raise billions of dollars and should raise at least one billion dollars. This option deserves serious study to determine if there are any reasons not to go forward with it and to establish sound procedures for implementation of the proposal. Similar possibilities should be explored for tax cases before the U.S. District Court and the Court of Claims.

Naval Petroleum Reserves

Running an oil field is a business and should not be a government activity. However, for the past decade the Naval Petroleum Reserve (NPR) has operated as a government-owned oil field. It has sold oil at rates far below the market price. It is also burdened with many unnecessary government regulations.

The Office of Management and Budget (OMB) estimates that about $2.5 billion in annual receipts can be generated from the sale of NPRs to the private sector. Critics allege that such oil should remain in the ground for security reasons. However, halting production is no longer a realistic option. Once production has begun, the wells cannot be easily plugged because oil would seep into areas from which it cannot be recovered. The government also owns the Strategic Petroleum Reserve, a preferable way to handle a crisis because it can pump oil 30 times faster than the NPRs.

Financial Asset Sales

A large amount of revenue can be generated by sales of federal loans. A 1984 Congressional Budget Office (CBO) study estimated a potential one-time net cash inflow to the Treasury of $95 billion if $208 billion of the federal loan portfolio were sold. The President's budget contains a much smaller, politically achievable, package of sales with a face value of $11.2 billion which, would generate about $5 billion in revenues for 1988. A Heritage Foundation study concludes that asset sales could realistically yield $10 billion for 1988.

Critics argue that loan asset sales do not constitute real deficit reduction. However, loan asset sales do increase the cash flow of government on a dollar for dollar basis. This enables Congress to meet its deficit reduction targets while putting into place spending reduction packages that generate larger savings in the out-years. Selling such loans also makes the federal subsidy imbedded in these loans come to light, potentially curbing program abuse. Precedent for this approach was established when Congress counted the Rural Electrification Administration (REA) pre-payment as savings in the 1988 budget resolution. This payment has the same upfront cash flow element as loan asset sales.

User Fees on Inland Waterway Projects

The Corps of Engineers (COE) currently spends $3 billion annually on multipurpose water projects. Under current law, COE user charges are low and in some cases nonexistent. Waterway users (i.e., commercial shippers) currently contribute only 8 percent of federal expenditures on the inland waterway system. The burden of waterway projects continues to fall on the taxpayers' shoulders. According to the Congressional Budget Office and the Heritage Foundation, if annual user fees that covered operating and capital costs were levied, they would reduce the deficit by $1 billion annually.

Below-cost user fees have had other harmful effects besides contributing to the size of the federal deficit. These include creating excess demand for new dredging and construction projects and promoting artificially high use of shipping for transporting goods rather than less costly modes of transportation.

Contrary to critics' claims, increased user fees would not be financially ruinous for U.S. shippers. The CBO has estimated that full-cost recovery user fees for ports and harbors would increase the cost of goods only slightly.

User Fees For Federal Credit Programs

Increased user fees on a wide variety of federal credit programs (Veterans Administration loans, Federal Housing Administration loans, Commodity Credit Corporation, export credit loans, maritime loans, education loans, and REA loans) have been proposed. The proposal is related to Grace Commission recommendations to improve federal credit policy. The basic proposal is to implement a 5 percent origination fee for most of these loans. The proposal would affect more than 85 percent of newly guaranteed loans that do not currently have such a fee in place. OMB estimates revenues of $1.5 billion for the first year.

Individuals and businesses who use such loans would have to confront the higher user fees. However, other borrowers must pay higher interest rates, receive less favorable credit terms or are unable to get credit at all because the federal government has channeled credit to the borrowers whom it favors.

Coast Guard User Fees

User fees could be established for U.S. Coast Guard services that provide direct benefits to commercial mariners and other users. According to CBO, such user fees could generate $900 million in deficit reduction annually.

Just as automobile owners assume the costs of building and maintaining roads and as local taxes pay the costs of police and fire protection, so should boat owners help defray the costs of federal services provided solely for their benefit. In addition, the burden on most recreational boat owners would be small; the CBO estimates that fees for recreational boaters would be less than $20 per year. The impact of fees on the fishing industry and commercial shippers would be greater but not overly burdensome. User fees would merely cause industry prices to reflect more accurately the real cost of these commercial activities.

Auction of the Unassigned Spectrum

The Administration proposes the use of auctions, instead of the present practice of using hearings and lotteries, to assign Federal Communications Commission licenses for use of the unassigned spectrum. Revenues generated from such sales are estimated to be $600 million annually.

Auction authority will not affect the terms of licenses awarded and will not apply to licenses awarded in any medium of mass communications, or for public safety or amateur services. Public auctions will capture the true value of the license and give taxpayers a return for the use of the spectrum, which is public property.

Excess Real Property

The President's Private Sector Survey on Cost Control and the General Accounting Office (GAO) point to the need for better policies for federal asset disposal. Because agencies are often not compensated for asset dispositions, little incentive exists for such sales. Congress must also approve even very small sales.

Critics point out that such sales may disrupt the real estate market. However, such sales could be phased-in over a period of years. Furthermore, the amount that is currently marketable represents only one-half of one percent of all federal landholdings. Selling such property could yield as much as $1.0 billion in annual receipts, according to the Private Sector Survey on Cost Control.

Private ownership would transform nonessential federal real property into taxable, wealth-creating assets. If federal property of minimal national significance were transferred to the the private sector, all parties would benefit: developers could use the property for profit-making ventures, local communities would have a larger tax base at their disposal and the federal government would gain revenues to offset the deficit.

Price-Indexed and Gold-Backed Bonds

Price-indexed bonds and gold-backed bonds could save the Treasury interest expense. These inflation-proof bonds would compensate investors for unexpected changes in the inflation rate. Thus, the Treasury would no longer have to compensate investors for inflation uncertainty when issuing new bonds. One third of all new bonds in Great Britain have been so indexed since 1981. Further studies should be done to estimate the impact of inflation-proof bonds in reducing our federal deficit.

For example, estimates from the Heritage Foundation suggest that such inflation-proof bonds could, with as little as a two percentage point reduction in the cost of federal borrowing, generate up to $12 billion in annual interest saving and deficit reduction. Other estimates predict a more modest savings of three billion dollars in the first few years, increasing to $12 billion after full implementation of the program.

Amtrak

According to OMB, privatization of Amtrak could yield $1.6 billion in 1988. Privatization of some or all of the system could be made a sound political alternative by giving key constituencies (Amtrak employees, management, passengers) an ownership stake in the railroad and eliminating subsidies through improved efficiency. By turning Amtrak assets over to the private sector in return for terminating the subsidy, a net savings to the taxpayer results. Moreover, if Amtrak were private, it would pay local, state and federal taxes.

Proponents of such a strategy argue that the current subsidy provides little incentive to cover costs. Cutting subsidies would therefore effectively reduce federal outlays and promote efficiency. Amtrak carries less than 0.3 percent of all intercity passenger traffic in this nation. Even on the heavily traveled portions of the Amtrak route structure, more than half of its heavily subsidized patrons have incomes above $30,000, resulting in an Amtrak subsidy that serves to redistribute income upwards.

As is the case with most federal subsidies, the subsidies afforded Amtrak could have created several times as many new jobs in the private sector. If Amtrak were sold to the private sector, profitable and popular routes would not be eliminated but rather would be operated by more cost-efficient, taxpaying, private owners.

Military Bases

According to the President's Private Sector Survey on Cost Control, many Department of Defense installations can be consolidated and many others can be eventually phased-out. A portion of the real property associated with these sites could be sold to the private sector or state and local governments. Although smaller communities could suffer adjustment problems, these problems could be overcome with an orderly phase-out of these installations.

Selling or renting commissaries for private sector usage and management is also another source of revenue. Investigations have shown that such commissaries are operated inefficiently and are heavily subsidized. Studies by the Grace Commission have shown that military and private sector pay scales are equivalent. Therefore, the commissary subsidy is not needed. Even if such subsidies were useful, a voucher system would be far more efficient than federally operated stores.

Deficit reduction derived from base closures and consolidations and rental income from privately owned commissaries could yield at least $1.5 billion annually, according to the Grace Commission.

Conclusion

Table III summarizes the revenue raising options discussed above.

TABLE III
REVENUE RAISING OPTIONS

Option Description	Fiscal Year 1988 Revenues (Billions of dollars)
Reconciliation Substitution	$3.9
Capital Gains	$3.5-7.7
Tax Court Docket Relief	$1.0-3.0
Military Base Reform	$1.5
Naval Petroleum Reserve Sales	$2.5
Excess Real Property Sales	$1.0
Credit User Fees	$1.5
Financial Asset Sales	$5.0-10.0
Price-indexed Bonds	$3.0-12.0
Amtrak	$1.6
Inland Waterways User Fees	$1.0
Coast Guard User Fees	$0.9
Unassigned Spectrum Auction	$0.4
TOTAL REVENUE RAISING OPTIONS	$26.8-47.0

Each of these proposals would help to enable the Congress to meet its deficit reduction targets in an economically constructive manner, without slowing economic growth, exacerbating poverty, increasing unemployment or harming the competitiveness of U.S. business. The pattern of federal spending, however, forces one into a pessimistic appraisal when assessing the uses to which these revenues might be put. With federal revenues at record levels for a peacetime economy, and for many wartime periods for that matter, it is hard to believe that additional federal revenues will result in anything but additional federal spending. To the degree that these proposals result in more spending, then whatever beneficial features that they possess in the abstract will at least in part be negated.

It is possible for you to make tax and spending adjustments that we believe will ensure a continuation of our near-record peacetime expansion. We urge you to take the constructive course we have recommended rather than burden the economy with a major tax increase, which is guaranteed to increase the misery of many of our citizens.

Thank you for the opportunity to present our views on the important issue of how best to raise the revenues necessary to meet the budget resolution requirements.

Mr. PICKLE. Thank you.

Next we will hear from Dr. Rudy Oswald representing the American Federation of Labor and Congress of Industrial Organizations.

Dr. Oswald.

STATEMENT OF RUDOLPH A. OSWALD, DIRECTOR, DEPARTMENT OF ECONOMIC RESEARCH, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY ROBERT M. McGLOTTEN, DIRECTOR, DEPARTMENT OF LEGISLATION

Mr. OSWALD. Mr. Chairman, accompanying me is Robert McGlotten, director of our department of legislation.

I ask that my entire testimony be made part of the record and I would like to summarize that testimony.

The AFL–CIO appreciates this opportunity to make recommendations to help the committee in its quest for revenue. We have consistently emphasized the need for revenue to offset the effects of the 1981 tax cuts, to reduce the deficits and to pay for any needed defense increases. With a budget deficit estimated at nearly $140 billion, and that is expected to exceed $2.6 trillion, raising revenue is particularly important, and we support your efforts. But central to our support for additional revenue is our strong belief that any new taxes being considered should be based on the ability to pay. We urge that the revenue be sought from the individual and corporate income tax and the estate and gift tax.

The AFL–CIO urges that progressive taxation, a fair and equitable distribution of the Nation's tax burden be the central theme of the bill that the Ways and Means Committee reports to the House in keeping with the concurrent resolution on the budget for fiscal year 1988.

We oppose any new or expanded sales, excise or other consumption taxes as regressive, contrary to the goal of tax justice and the intent of Congress last year in enacting the 1986 reforms. We remain vigorously opposed to any new efforts to tax employer-provided workplace benefits.

Specifically we suggest that the additional funds be generated in some of the following areas:

(*a*) Maintain the top individual tax rate at 38½ percent rather than the 28 percent under current law.

(*b*) Make the current individual tax rate of 33 percent explicit rather than to phase-in/phase-out rate.

(*c*) Reduce the corporate tax rate to 38½ percent rather than the current 34 percent.

(*d*) Change the foreign tax credit to a deduction and eliminate the deferral privilege for U.S. corporate income earned abroad.

(*e*) Impose a surtax on upper income individuals and corporations.

(*f*) Close the capital gains at death loophole and eliminate reductions in the estate and gift tax rates.

(*g*) Close such loopholes as limited partnerships and preferential accounting rules.

Revenue from these sources far exceeds the $19.3 billion in revenue called for by Congress in fiscal 1988, and the 3-year goal of

$64.3 billion. The proposals will not only yield this needed revenue, but will do so fairly and equitably. The proposed changes that we recommend would also offset the loss of revenue after 1988 anticipated as a result of the 1986 Tax Act.

The 1986 tax bill removed most of the working poor from the tax rolls and required American corporations to shoulder a fairer share of the tax burden. But the legislation went too far in cutting tax rates for the wealthy individuals and highly profitable corporations. We urge that the promise of tax reform be kept and progressive rate schedules be enacted that reflect the principle of taxation based on the ability to pay principal. Beyond the matter of tax receipts is the broader issue of social responsibility demonstrated by the share of taxes required of individuals and corporations. Taxpayer morale and support by Americans of the fiscal underpinnings of the Federal Government can be ensured only by Congressional action that spreads the tax burden equitably.

The AFL–CIO urges Congress to freeze the top individual tax rate at 38½ percent rather than to reduce it to 28 percent. The 38½ percent rate would apply to taxable income above $225,000, and would raise $4.7 billion in 1988, and $27.9 billion over 3 years.

The top rate has already been substantially reduced. Following World War II, the top rate was 91 percent. In 1965, it was reduced to 70 percent. And in the 1981 legislation, the top rate was cut to 50 percent. Then in 1987, the new rate of 38.5 percent is effective with a further reduction to 28 percent scheduled for 1988. In our estimation, this is too great a cut in the share of taxes to be carried by the wealthy.

Similarly, the current phase-out rate of 33 percent applying to taxable incomes of more than $71,900 should be made an explicit rate and not be hidden by the current phase-in/phase-out provisions. That proposal would raise some $2.8 billion in 1988, and $18.2 billion over three years.

Both of these proposals would only affect those with incomes of more than $90,000, and would leave intact the 1986 Tax Reform Act rates and exemptions for low and moderate income families.

We also recommend that the top corporate rate be cut to 38½ percent rate so that there would be a similar rate for corporations as for individuals.

The other alternatives that we have set forth, Mr. Chairman, provide some $34 billion in 1988 revenue and $166 billion over 3 years. We are not urging an increase of this magnitude but rather offer alternatives that we believe are the preferred options that the Congress should consider.

Revenue can be raised and it can be done in a fair and even-handed way. It can leave intact the 1986 tax structure for most Americans by asking the wealthiest to take a somewhat smaller cut in their taxes.

Thank you, Mr. Chairman.

[The statement of Mr. Oswald follows:]

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STATEMENT OF RUDOLPH A. OSWALD, DIRECTOR
DEPARTMENT OF ECONOMIC RESEARCH
AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

July 7, 1987

The AFL-CIO appreciates this opportunity to make recommendations to help the Committee in the quest for revenue. We have consistently emphasized the need for revenue to offset the effects of the 1981 tax cuts to reduce the deficit and to pay for any needed defense increases. With a budget deficit estimated at nearly $140 billion and a debt expected to exceed $2.6 trillion, raising revenue is particularly important and we support your efforts. But central to our support for additional revenue is our strong belief that any new taxes being considered should be based on the ability to pay. We urge that the revenue be sought from the individual and corporate income tax and the estate and gift tax.

The AFL-CIO urges that progressive taxation -- the fair and equitable distribution of the nation's tax burden -- be the central theme of the bill that the Ways and Means Committee reports to the House in keeping with the Concurrent Resolution on the Budget for Fiscal Year 1988.

We oppose any new or expanded sales, excise, or other consumption taxes as regressive and contrary to the goal of tax justice and the intent of Congress last year in enacting the 1986 reforms. We remain vigorously opposed to any renewed attempts to tax employer-provided workplace benefits.

Specifically, we suggest that the necessary funds be generated in the following areas:

A. Maintain the top individual tax rate at 38.5 percent, rather than the 28 percent under current law;

B. Make the current individual tax rate of 33 percent explicit, rather than a phase-in, phase-out rate;

C. Reduce the corporate tax rate to 38.5 percent, rather than the current 34 percent;

D. Change the foreign tax credit to a deduction and eliminate the deferral privilege for U.S. corporate income earned abroad;

E. Impose a surtax on upper income individuals and corporations;

F. Close the capital gains at death loophole and eliminate reductions in the estate and gift tax rates; and

G. Close such loopholes as limited partnerships and preferential accounting rules.

Revenue from these sources far exceeds the $19.3 billion in revenue called for by Congress in Fiscal Year 1988 and the three-year goal of $64.3 billion. The proposals will not only yield this needed revenue, but will do so fairly and equitably. The proposed changes that we recommend would also offset the loss of revenue after 1988 anticipated as a result of the 1986 Tax Act.

The Budget Resolution calls for $5.9 billion more in defense outlays in 1988 if revenues are raised to pay for the additional amount. That increased outlay figure would rise to $17.4 billion over three years, and $29 billion more in budget authority.

The AFL-CIO has consistently maintained that the federal government has the responsibility to provide for social needs and military strength necessary to protect national interests. While the AFL-CIO has in the past opposed efforts to transfer a percentage of funds earmarked for defense to social spending, the Administration wants to shift money in the opposite direction. Neither trade-off is appropriate. The Constitution calls for both securing the national defense and protecting the general welfare.

The 1986 tax bill removed most of the working poor from the tax rolls and required American corporations to shoulder a fairer share of the tax burden. But the legislation went too far in cutting tax rates for wealthy individuals and highly profitable corporations. We urge that the promise of tax reform be kept, and progressive rate schedules be enacted that reflect the principle of taxation based on the ability to pay. Beyond the matter of tax receipts is the broader issue of social responsibility demonstrated by the share of taxes required of individuals and corporations. Taxpayer morale and support by Americans of the fiscal underpinnings of the federal government can be ensured only by Congressional action that spreads the tax burden equitably.

The AFL-CIO urges Congress to freeze the top individual tax rate at 38.5 percent, rather than reduce it to 28 percent. The 38.5 percent rate would apply to taxable income above $225,000 and would raise $4.7 billion in 1988 revenue and $26.9 billion over three years.

The top rate has already been substantially reduced. Following World War II, the top rate was 91 percent. In 1963, it was reduced to 70 percent, and in the 1981 legislation, the top rate was cut to 50 percent. Then in 1987, the new rate of 38.5 percent is effective, with a further reduction to 28 percent scheduled for 1988. In our estimation this is too great a cut in the share of taxes to be carried by the wealthy.

The current phase-out rate of 33 percent applying to taxable incomes of more than $71,900 should be made an explicit rate of 33 percent and not be hidden by the current phase-in, phase-out provisions. It would apply to taxable incomes between $71,900 and $225,000. This proposal would raise $2.8 billion in 1988, and $18.2 billion over the three-year period.

Both of these proposals would only affect those with incomes of $90,000 or more and would leave intact the 1986 Tax Reform Act rates and exemptions for low and moderate income families.

We also recommend that the top corporate rate be cut to 38.5 percent, rather than to 34 percent as proposed. This proposed 38.5 percent rate is substantially lower than the 46 percent rate applied to taxable income of $100,000 or more that was in effect until June 30 and would yield approximately $4 billion in 1988 and $14 billion in three years. This rate would also eliminate the anomaly under the current code, where corporations with taxable income of $100,000 to $335,000 would pay a marginal rate of 39 percent under current law, and for wealthier corporations, the marginal rate would drop to 34 percent.

The share of taxes paid by corporations has been dropping since the mid-1950s when business financed over a quarter of the federal budget. By 1984, only 8.5 percent of federal tax revenues were from corporations.

The foreign tax credit should be changed to a deduction and the deferrability of taxes on profits earned abroad should be ended. American firms investing and producing abroad should not be subsidized by special U.S. tax privileges. Like state and local taxes, foreign income taxes should be considered a cost of doing business and should be deductions, not credits. Also the tax should be paid when the profits are earned, not at some future time (or never) as currently provided under foreign source income rules. In addition to ending a subsidy which encourages U.S. corporations to invest and produce overseas, these changes would yield approximately $10 billion in 1988 and $35 billion over three years.

We support a 5 percent corporate surtax on tax over $10,000 and a 5 percent surtax on individuals with a tax liability higher than $10,000. Such a levy should be applied to wealthier corporations and wealthier individuals who are best able to afford the additional burden. This would affect primarily families with incomes of over $70,000. Revenues would amount to $3.3 billion from the corporate surcharge the first year, and $15.7 billion over three years. The surtax on individuals would amount to $3.1 billion in 1988 and $16.7 billion over three years.

The estate and gift tax represents a source of revenue and tax equity. We recommend that the rates be frozen at the 1987 level rather than suffer the revenue loss that would result from dropping the rate to 50 percent on transfers of

over $2.5 million. In addition, we believe that Congress should use this opportunity to end the revenue losses resulting from the present law non-taxation of capital gains passed on to heirs. A three year revenue gain of $12.6 billion would result.

The AFL-CIO also supports the proposals to tax as corporations the "Master" Limited partnerships that are publicly traded and to put an end to the many opportunities for tax avoidance through accounting techniques such as inventory pricing and cash rather than accrual based deductions. Such measures would raise as much as $6 billion in 1988 revenue and $27 billion over the 1988-1990 period.

We repeat our strong opposition to the use of regressive excise taxes and general sales or value added taxes to raise revenue. Such taxes put an unfair burden on low- and moderate- income consumers who are less able to pay the additional taxes.

We believe that turning to excise taxes now would represent a breach of faith with the American people. Instead of using the income tax system that is based on ability to pay, a shift to excise taxes would be a move towards a regressive tax structure. Increasing excise taxes merely creates more inequity in the tax system. They are bad tax policy.

Just one note on the many other alternatives listed in the options of June 26, our opposition to taxing employee benefits remains strong. This is an issue that goes beyond tax and budget issues and touches on basic social policy. Attempts to reap fiscal rewards by taxing employee benefits is grossly unfair to the tens of millions of American workers who depend on benefits that have become the basis of a life-support system.

Up to 140 million Americans now rely on job-related health care insurance protection -- so this is hardly an unnecessary benefit. To tax health and life insurance, pensions, education, legal services, child care and other employer-paid benefits as if they were income would destroy established social policy without providing an alternative.

The AFL-CIO proposals amount to nearly $34 billion in 1988 revenue and to $166 billion over three years. We are not urging an increase of this magnitude, but rather offer alternatives that we believe are the preferred options that the Congress should consider.

Revenue can be raised and it can be done in a fair and even-handed way. It can leave intact the 1986 tax structure for most Americans, by asking the wealthiest to take a somewhat smaller cut in their taxes.

AFL-CIO Options To Meet Budget Targets
(Billions of dollars)

Proposals	1988 Revenue	Revenue over Three Years
Maintain top rate of 38.5%	$4.7	$26.9
Make 33% rate explicit	2.8	18.2
Lower top corporate rate to 38.5% instead of 34%	4.0	14.0
Enact a 5% surtax on individual income taxes of over $10,000	3.1	16.7
Enact a 5% surtax on corporate tax over $10,000	3.3	15.7
End foreign tax credit and deferral	10.0	35.0
Retain 1987 estate and gift tax rates and tax capital gains at death	--	12.6
Taxation of limited partnerships and accounting reforms	6.0	27.0

Mr. PICKLE. Thank you, Dr. Oswald.
Now, Mr. Huard, if you would proceed.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HUARD. Thank you, Mr. Chairman. We appreciate the opportunity to participate in this important inquiry.

NAM continues to believe that the best technique for lowering deficits is reduction of the overall growth rate of Federal spending and not the enactment of new or increased taxes.

Our positions on the specific revenue raising options, as described in the staff pamphlet prepared for the committee's use in these hearings, are as follows:

First, on income taxes. With the sole exception of increased revenues derived from lowering capital gains rates, we oppose any change that would increase Federal revenues from individual or corporate income taxes, whether through rate increases, rate freezes, or surtaxes, through the repeal or curtailment of any existing exemption, exclusion, deduction or credit, or through changes in definitions or accounting rules.

The Federal Government already raises a disproportionately high percentage of its total receipts from taxing income from work, savings and investment. This situation should not be further exacerbated. Income taxes are already amply progressive with the top 10 percent of the taxpayers shouldering about half the total burden.

Income taxes are already excessively complex. Administering another dosage of the "Death by a thousand cuts", as was done in 1982, and again in 1984 and again in 1986, is about the last thing this already overburdened system needs right now.

About the only simple changes that you could make are rate increases, or their economic equivalent surtaxes, and to these we are unalterably opposed.

Rate reductions were the explicitly promised—let me repeat that modifier—explicitly promised tradeoff for the massive base broadening that took place in last year's tax reform bill. Congress should not further erode its credibility by reneging on a promise that is not yet 10 months old.

On the subject of selective excise taxes, we oppose, without exception, any change that would increase Federal revenues derived from selectively imposed excise taxes. This position applies to increases in or extensions of existing taxes, as well as to the creation of any new selective excises. It applies to the entire range of potentially taxable products and services, from imported oil to the execution of securities transactions.

NAM is fundamentally opposed to taxes that are levied only on particular sectors of the economy. Such taxes are inherently distortionary, unfairly raising the price of taxed goods or services relative to those that are untaxed.

Let me turn now to the subject of general consumption taxes.

Subject to the observation that it would be far, far better if Congress did not raise taxes at all but cut spending instead, we believe

that the fairest and least counterproductive tax increase would be the imposition at a single uniform rate of an ad valorem transaction tax on the broadest possible base of goods and services.

There would, of course, need to be some type of adjustment for regressivity, perhaps a refundable income tax credit that phases out above certain income levels. Among the collateral advantages of such a tax are improved export competitiveness and the extraction of revenue from the otherwise untapped underground economy.

On the subject of employment taxes, we oppose without exception any change that would increase the employment tax burden of private sector employers and employees. Payroll tax levels are already excessive and contribute significantly to the competitiveness problems of many employers.

The unceasing rise of such taxes throughout this decade has for many employees completely negated any benefit from the rate cuts enacted in 1981 and 1986.

We oppose without exception any change that would increase Federal estate and gift tax revenues. NAM's long-term policy objective in this area is to see such taxes removed entirely from Federal use.

On the subject of miscellaneous non-tax revenue sources, we express no position for or against increased revenues from asset sales or user fees. I would note that selling Government assets provides a nonrecurring benefit that does nothing to reduce the long-term imbalance between outlays and revenues, and certainly I would hope that any such sales would have independent justification. I think many of the ones referred to by Dr. Rahn do have independent justification and should receive some serious consideration.

On the subject of user fees, I would caution that if you are going to impose user fees, they should be user fees, and not a hidden tax. To the extent that they recover more for the Government than the cost of the service, they are in effect a hidden tax, and we strongly recommend against that approach.

That actually concludes the summary of our positions. I would like to use the balance of my time to address briefly the subject of allegedly inadequate corporate income taxes. We keep hearing the corporations have to shoulder their fair share of the burden. I believe a brief examination of the national income accounts will disclose that on approximately $300 billion in corporate profits, the Federal Government collects about $110 billion in income taxes, an effective rate of about 33 percent. On personal income of $3.6 trillion the Government collects approximately $380 billion for an effective rate of 11 percent.

Frankly, corporations pay triple the effective rate of individuals in Federal income taxes. And suggestions that they are not shouldering their fair share are frankly hogwash and demagoguery.

Thank you, Mr. Chairman.

[The statement of Mr. Huard follows:]

TESTIMONY
OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS

ON OPTIONS FOR ACHIEVING THE REVENUE RECONCILIATION TARGETS
UNDER THE FISCAL YEAR 1988 BUDGET RESOLUTION

BY
PAUL R. HUARD
VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JULY 7, 1987

Thank you, Mr. Chairman. I am pleased to be here today to present NAM's views on options for raising revenues to meet the reconciliation instructions contained in H.Con.Res. 93, the Concurrent Resolution on the Budget for Fiscal Year 1988. Among other things, that resolution directs the Committee on Ways and Means to raise new revenues of $64.3 billion over the next three fiscal years: $19.3 billion in FY88, $22 billion in FY89, and $23 billion in FY90.

Before proceeding any further, however, I first would like to congratulate the Committee and its Chairman on the prompt and wise decision to hold these hearings. It is a long-standing position of NAM that tax legislation should only be developed on the basis of an adequate public hearing record containing representative views from all affected sectors of the economy. Too often, major changes in our tax laws that have never been subjected to public scrutiny and comment are agreed to behind closed doors. We therefore greatly appreciate this opportunity to participate in the legislative process on behalf of our members.

I. Introduction

Candor requires me to note that, when the conference agreement on H.Con.Res. 93 reached the floor of the House and Senate, NAM wrote each member of Congress urging a negative vote. Although we continue to believe the nation would be better off had the resolution been defeated, that legislative battle has now been fought and lost. And while some have expressed doubts about the wisdom of developing a painfully difficult tax bill that may well be vetoed, we believe that by embarking expeditiously on such development, the Committee has exercised the only responsible choice open to it. You are to be commended for that.

Let me turn now to the subject matter of this hearing, which is set forth in a 291-page pamphlet entitled "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means." (JCS-17-87), June 25, 1987. This pamphlet was prepared by the staff of the Joint Committee on Taxation in conjunction with the staff of this Committee. We acknowledge the fact that it is intended simply as a list for discussion purposes, and is not to be construed as a recommendation of the Joint Committee staff or of the staff or any member of this Committee. Included in the list are the revenue increase recommendations made by the President as part of his FY88 budget proposal.

In the balance of this testimony, I will group the listed options into six generic categories, and explain our views on each such category. For the most part, the views stated will apply with equal force to all items within the category. In some cases, however, I will add comments directed only at a particular item within the category. The six broad categories I will comment on are: (a) income taxes; (b) selective excise taxes; (c) general consumption taxes; (d) employment taxes; (e) estate and gift taxes; and (f) miscellaneous non-tax revenue sources.

II. Opposition to Income Tax Increases

NAM opposes without exception any option that would increase the revenues derived from the federal individual and corporate income tax systems. More specifically, we would oppose and urge the President to veto any bill having one or more provisions which would:

- -- extend, for any period, any individual or corporate tax rate intended under the Tax Reform Act of 1986 to be transitional in nature; or
- -- increase, for any period at any bracket level, any marginal tax rate for either individuals or corporations that was intended under the Tax Reform Act of 1986 to be a permanent rate; or
- -- impose, on any individual or corporate income tax liability arising under existing law, any surtax whatsoever, regardless of the rate or duration thereof; or
- -- repeal or curtail, for any period, any credit, deduction, exclusion or exemption available under existing federal individual or corporate income tax law; or
- -- repeal, curtail or otherwise modify, for any period, any existing definition or accounting rule in a manner that would increase the federal individual or corporate income tax liability of any taxpayer.

Our reasons for opposing any individual or corporate income tax increase of any kind are summarized below:

Reliance on Income Taxation Is Already Excessive. Under present law, the federal government raises nearly 92% of its revenues from income and payroll taxes, in other words, by taxing income from work, savings and investment. Taxes on consumption, on the otner hand, account for only a little over 5% of the total. Compared to the much more balanced ratios that prevail in other developed countries, our federal tax system indulges consumption and penalizes labor and thrift to a degree that is very nearly scandalous. Further revision of the federal tax system--whether or not such revision generates any net increase in revenues--should be directed at redressing this imbalance by shifting the burden of taxation more onto consumption.

Congress Should Not Renege on Its Tax Reform Promises. Reduction in the marginal rates of taxation on both individual and corporate income was the explicitly-promised tradeoff for the massive base-broadening which took place under the Tax Reform Act of 1986. Congress should not further erode its credibility by brazenly reneging on that promise less than ten months after its enactment. This rationale applies to all increases in marginal rates, whether direct or circuitous. In other words, we are opposed not only to outright increases in the existing marginal rate structure, but also to "freezes" in transitional rates, the addition of new rates and brackets, or the imposition of surtaxes.

Income Taxes Already Are Sufficiently Progressive. The argument is often heard that the federal income tax system should be more "equitable" and "progressive," and based on "ability to pay." These are thinly-disguised code words for raising taxes on corporations and upper-income individuals. While doing this may provide emotional gratification to some, it cannot be justified on the basis of the facts.

It is true, for example, that individuals pay almost four times as much federal income tax as corporations. Personal income, however, is nearly 12 times as large as corporate profits--nearly $3.6 trillion versus about $300 billion. The relevant fact emerging from all this is that the effective rate of federal income taxation for corporations is around triple that of individuals [in approximate terms, 33% vs. 11%]. This gross disparity, incidentally, also prevailed prior to the tax reform act of 1986. indeed, for at least several decades prior to the enactment of the 1986 reform legislation, the effective corporate rate was consistently at least twice that of individuals. The 1986 changes, which increased corporate income taxes by some $120 billion over 1987-90 to pay for individual tax cuts of about the same amount over the same period, merely served to make an already bad situation quite a bit worse.

As regards individuals, the plain fact is that, before and after the Tax Reform Act of 1986, the top 10% of individual taxpayers pay about 50% of the total individual income tax burden. This degree of progressivity is, in our view, more than ample. Moreover, the 1986 Act has already added an unbelievable amount of clutter to the Internal Revenue Code in the form of complex rules and phase-outs designed to limit the amount of tax relief flowing to upper-income taxpayers. This is a problem that needs no further aggravation. Finally,

hindsight has demonstrated, both with regard to capital gains tax rates and the marginal rates of tax on ordinary income, that lowering such rates actually results in increased tax receipts from upper-bracket taxpayers.

The Income Tax System Should Tax Income, Not Gross Receipts. The Congress in recent years has displayed a regrettable tendency to raise revenue by denying or limiting deductions for ordinary and necessary business expenses. The current limitations on deductibility of meal and entertainment expenses are but one example of this. Another is the proposed option that would deny a deduction for 20% of advertising costs.

NAM believes it is essential to preserve the traditional concept that, as applied to business taxpayers, the federal income tax system is a tax on net income, i.e., on gross income less all costs incurred in producing such income. Denial of a deduction for all or part of costs incurred in the ordinary course of trade or business tends to change the nature of the system from a tax on income to a tax on gross receipts. Gross receipts are an inappropriate and inequitable base for the imposition of federal taxes on business income, leading to widely disparate tax burdens among taxpayers.

We therefore oppose all options that would repeal or curtail deductions for ordinary and necessary business expenses, whether specifically targeted at a particular type of expenditure or included as part of across-the-board cutbacks on alleged "tax preferences." Singling out one or more types of business expenditure for nondeductible treatment--in full or in part--is objectionable in principle. Further, it is especially deplorable when the underlying motivation is a naked attempt to extract additional revenue, devoid of any consideration for the reasoned application of fair and consistent tax policy principles.

Additional Complexity Is Clearly Undesirable. About the last thing needed just now by most taxpayers is another dosage of the "Death by a Thousand Cuts," as was administered to them in the tax laws of 1982, 1984 and 1986. The cumulative effect of these statutes has been to subordinate sound tax policy principles to revenue demands and political considerations to such a degree that the system may be on the verge of foundering. In area after area, the need to extract just a little more revenue has resulted in rule changes so byzantine and convoluted that they are beyond the ability of many taxpayers to understand and, in some cases, perhaps beyond the ability of many IRS personnel to enforce.

If one thing is clear, it is that the almost continuous process of encrusting the Internal Revenue Code with more exceptions to exceptions, more limitations within limitations, more alternative calculations applied to the same set of numbers, etc. should be stopped dead in its tracks. Possibly nothing would be of greater benefit to both taxpayers and the Treasury than if Congress made no changes whatsoever in the federal income tax laws for a period of five to ten years. And whenever further changes are made, the palpable need for simplification--a goal which unfortunately dropped completely out of sight during the 1985-86 "reform" process--should be a major criterion against which all future changes are measured.

One Small Exception After All. Under the Tax Reform Act of 1986, long-term capital gains will after 1987 be taxed at the same rate as ordinary income. NAM has consistently supported use of a preferentially lower tax rate on capital gains, both as a means of compensating investors for risk-taking and as a device to mitigate the taxation of purely illusory gains resulting from inflation. Past results strongly indicate that the Treasury's receipts from capital gains taxes can actually be expected to increase when the capital gains tax rate is lowered. Accordingly, a significant reduction in the current capital gains tax rate, say to 15% as suggested at page 242 of the June 25 staff options pamphlet, is the one--and only--revenue-raising income tax change that NAM would support. Contemporaneously with such a change, Congress should consider whether the holding period should be lengthened somewhat so as not to promote short-term speculation.

III. Opposition to Selective Excise Taxes

NAM opposes without exception any option that would increase the amount of federal revenue derived from selectively-imposed excise taxes. Specifically, we would oppose and urge the President to veto any bill that would: increase any selectively-imposed excise tax now in effect; or extend any such tax now in effect but due to expire; or create any new selectively-imposed excise tax.

Our reasons for opposing any further expansion of the system of selective federal excise taxes are summarized below:

Consumption Taxation Should Be Neutral. A desire to make the income tax system more neutral was one of the driving forces behind the Tax Reform Act of 1986. NAM believes the principle of neutrality should also be applied to the taxation of consumption. As a matter of long-standing policy, we are fundamentally opposed to taxes that are levied only on particular sectors of the economy. Such taxes are inherently distortionary because they raise the price of taxed goods and services relative to those that are untaxed. In some cases, for example oil import fees or gasoline taxes, wide variances in consumption patterns can result in geographic discrimination as well.

Furthermore, to the extent that deficit reduction is the motivating factor for seeking new revenues, selective excises are an inappropriate source of such revenues. Our deficit problem is national in scope, affecting all sectors of the economy. The same should be true of the solution. Particular industries or activities should not be singled out and required to bear the burden of deficit reduction while other sectors are left untouched.

If consumption taxation is to be employed as a deficit reduction tool, then a general consumption tax is a far superior method, because it would apply more broadly and evenly throughout the economy. [See Part IV of this testimony.] Indeed, if a general consumption tax system is adopted, it should not be superimposed on the existing system of selective excise taxes. Instead, to achieve fairness and neutrality, all such selective excises should then be repealed.

Regressivity of Selective Excises Cannot Be Adjusted For. It is now generally recognized that many of the selectively-imposed excises currently in use are highly regressive in nature, because the taxed goods or services are widely consumed or utilized by low-income individuals. Such regressivity is generally viewed as an undesirable feature. However, because of the variations in the consumption patterns of selectively-taxed items, there is no feasible method for directing relief to those low-income consumers actually impacted. If, on the other hand, all consumption is taxed, then the universality of the impact makes it possible to correct the regressivity of such a system in a manner that is both effective and efficient. [See Part IV of this testimony.]

Excise Taxes Should Not Be Regulatory Devices. Certain excise taxes now in use are viewed by some as legitimate techniques for discouraging the consumption of the taxed items. Not surprisingly, these are sometimes called "sin" taxes. Recently, it has become fashionable to argue that these "sin" taxes should further be increased to recover the "costs" that the taxed items are asserted to impose on society. Whether or not the assertion is true, the argument is an exceedingly dangerous one because of its broad potential applicability.

For example, a certain number of deaths, injuries or illnesses each year can be associated with traffic accidents, or with heart and circulatory problems, or with hypertension, and so on. These proximate causes can in turn be associated with automobiles, cholesterol, and salt, respectively. Does this mean we should have an excise tax on cars and on eggs? Should all food items be subject to a differential excise based on salt content? I suggest the answer is unambiguously no. Not only is the relationship between a taxed item and societal costs sometimes arguable, the calculation of such costs is itself a highly speculative exercise, all of which should make it abundantly clear that what we have here is a wholly imprecise--and therefore improper--basis for assessing taxes.

Certain Excises Would Adversely Affect Competitiveness. Many of the excise taxes now in effect are applied to finished goods and as a result do not affect the cost of producing such goods. This is not the case with certain major new excises now being considered, most notably oil import fees and various forms of energy taxes. These would increase industrial production costs because they would apply to feedstocks consumed and/or to energy utilized in the production process. Thus, an additional ground for opposing oil and energy-related taxes is that imposition of such taxes would adversely affect our ability to produce competitively-priced goods in both domestic and world markets.

IV. Position on a General Consumption Tax System

NAM believes that the key to lowering deficits must be significant reductions in the growth of federal spending across the board and not the

enactment of new or increased taxes. If in addition to spending reductions, however, Congress is nevertheless determined also to increase federal tax revenues as part of a deficit reduction program, then the fairest and least counterproductive approach is the implementation of a general consumption tax system. A general consumption tax should be designed in accordance with the following principles:

A Transaction-Based Tax Is Best. A general tax on consumption should apply on a transaction basis, i.e., it should be imposed on an ad valorem basis when a taxable product or service changes hands. Either a retail sales tax or a value added tax ("VAT") would satisfy this criterion, the latter being no more than a multi-stage variation of the former. Indirect methods, such as the so-called subtractive method tax described in the staff options pamphlet [pp. 79-80] are less attractive for several reasons. One is that the selling firm does not compute the tax on the basis of a specific sale to a buyer, but rather aggregates all sales and all purchases, subtracts the latter total from the former, and pays the tax on the net difference. In such a situation, the firm's ability to pass the tax forward to any specific buyer must be rated as suspect. Since the whole idea of a consumption tax is to pass the tax forward to ultimate consumers, and not to increase the costs of industrial production, this is a considerable drawback. From an enforcement standpoint, another consideration is that a VAT, which is an "invoice and credit method" type of tax, is thought to leave a much better audit trail throughout the production/distribution chain.

It Should Be Broadly-Based and Neutral. A general consumption tax should apply at a single uniform rate to the broadest possible base of taxable goods and services, so as to spread its burden equitably across the entire economy, while at the same time permitting the tax rate to be as low as possible given the amount of revenue intended to be raised. Omission of the service sector from the tax base, as occurs under many state sales tax systems, would be unfair, requiring higher taxes on a narrower base and disproportionately impacting those groups that consume more goods than services. A multiplicity of different rates, in addition to seriously eroding the goal of neutrality, would also add undesirable complexity. And, if a general consumption tax is enacted, then as previously noted, the goal of neutrality will be most fully achieved if at the same time all existing selective excise taxes are repealed.

It Should Apply to Full Value and Be Visible. A general consumption tax should apply to the full value of taxable goods and services, up to and including retail value, and the tax should be separately stated and readily identifiable at that level. Transaction-based tax systems that omit the retail level will have an unnecessarily narrow tax base. The need for the tax to be visible at the retail level is obvious: taxpayers should know how much they are paying for the cost of being governed. Hidden taxes are too easily raised. This last consideration militates heavily against usage of a subtractive method tax, which is more likely to get buried in the overhead costs of producers and distributors.

It Can and Should Be Adjusted for Regressivity. There is no doubt that a general consumption tax system can be regressive. Fortunately, the system's regressivity can be adjusted for in a manner that is both effective and efficient, i.e., in such a way that impacted low-income consumers get the relief that is intended for them and no unintended benefits are conferred on others. This can be achieved by providing, through the income tax system, a refundable credit that is phased out above certain income levels. [An obvious analogy is the earned income credit under present law.]

As previously noted, it is impossible to adjust for regressive impact of the existing federal excise taxes. It is simply not feasible, on a person-by-person basis, to match up the two relevant facts--whether the person bought the taxed item and, if so, whether his or her income level is such as to warrant relief--and then to provide the desired relief.

Under a general consumption tax system, the universal applicability of the tax to all consumption eliminates any need to determine if a low-income consumer was impacted--the existence of such impact may safely be assumed. Whether and how much relief is available is determined on the basis of a person's income tax return. Because of the phase-out provision, higher income individuals not needing relief would not get any. Because the credit would be refundable, those with incomes so low as to have little or no tax liability would still get the full amount of intended relief.

There undoubtedly are other ways to adjust a general consumption tax system so as to correct the problem of regressivity. One common approach is to exclude certain items from the tax. Food and medicine are typical exclusions under many state sales tax systems. On the assumption that one can reach a reasonably accurate determination of what low-income groups consume, this technique will tend to achieve the desired results. Exclusions, however, erode the neutrality of the system and moreover are highly inefficient because they benefit all income levels, including those perfectly able to stand the burden of a general consumption tax.

Taxpayers Other Than Ultimate Consumers Must Get a Credit for Taxes Paid. If a general consumption tax is levied at multiple points in the production and distribution process, credits for taxes paid must be allowed to prevent the pyramiding of taxes. This is not a problem with a retail sales tax, since there is only one point of collection. Such credits typically are allowed under the "invoice and credit method" VAT described in the staff options pamphlet. [p. 79]

If such credits are not allowed, the government will collect much more than the nominal rate of tax. For example, suppose an article is sold successively by a manufacturer, wholesaler and retailer, for $20, $40 and $80, respectively, and the nominal rate of tax is 5%. Under an invoice and credit method VAT, the manufacturer will collect and remit $1; the distributor will pay $1, collect $2 and remit the difference of $1; the retailer will pay $2, collect $4 and remit the difference of $2. The government gets a grand total of $4, exactly what it would get under a straight 5% retail sales tax. Either way, the ultimate consumer pays $84 for his purchase. Without the credits at the intermediate points of the chain, however, the government would collect a total of $7, an effective rate of nearly 9% even though the nominal rate is 5%.

It Should Not Apply to Exports. Taxes paid by a manufacturer are part of the cost of doing business and, under ordinary circumstances, are reflected in the price of the product. Many of our industrial competitors, however, finance a significant part of the costs of their governments with VAT-type taxes which are rebatable on exports. The major taxes paid by U.S. manufacturers are payroll and corporate income taxes which, although they may make up part of a product's cost, are not rebatable if that product is exported. This disparity unquestionably puts U.S.-based producers at a competitive disadvantage in export markets.

Nevertheless, these are the rules we have agreed to play by as signatories to the General Agreement on Tariffs and Trade ("GATT"). Our trading partners are no fools, and therefore are not about to agree to any change in the GATT rules that would wipe out their advantage. We do have the option, however, of financing a greater part of the cost of our federal government with taxes that under GATT rules are rebatable on exports. A broad-based general consumption tax would be just such a tax. An even greater boost for export competitiveness could be achieved if part of the revenues from a general consumption tax system were utilized to permit reductions in payroll and corporate income taxes.

Consumption Tax Revenues Should Not Be Used To Finance Additional Spending. Revenues derived from a general consumption tax system should be used primarily to reduce the federal deficit and no part of such revenues should be used to finance additional government spending. Simply described, our deficit problem is that the national government takes in revenues totalling around 19% to 20% of GNP, but spends at a rate of 23% to 24% of GNP. New tax revenues should be used principally to close this gap, not to further inflate an already excessive level of government outlays.

It is also desirable that a significant portion of these new revenues be applied to reduce existing federal taxes. Two particular applications come to mind immediately: (1) enactment of a refundable credit under the individual income tax system to provide the regressivity adjustment discussed previously; and (2) repeal of all existing selective excise taxes to prevent double taxation and achieve neutrality. Other applications might be considered with an eye to further improving the interplay between the individual and corporate income tax systems. If, for example, the top corporate rate were lowered to match the top individual rate, and the systems were properly integrated so that corporate earnings paid out as dividends to shareholders were not doubly taxed, much of the gamesmanship now surrounding the form of doing business [e.g., corporation vs. partnership] simply would not occur.

Discussion of Staff Options

The brief discussion in the staff options pamphlet [pp. 79-81] of a possible general consumption tax system identifies two major variants. One is a value added tax, an "invoice and credit" method under which every taxpayer save the ultimate consumer collects the VAT tax on its sales but reduces the amount it remits to the government by taking a credit for the amount of VAT paid on its purchases.

The other option is a business alternative minimum tax ("BAMT"), a subtractive method under which each taxpayer in the production/distribution chain--save again the ultimate consumer--subtracts from its aggregate sales the amount of its aggregate purchases from other firms, and pays the prescribed BAMT rate on the difference. Payroll and income taxes could be allowed as credits against BAMT liability, thus giving rise to the "minimum tax" nomenclature.

When the VAT and BAMT are measured against the design criteria enumerated above, it is clear that the VAT is the hands-down winner. The VAT satisfies all the criteria whereas the BAMT fails in a number of important areas: (a) it is a hidden tax which could not be made visible to the ultimate consumer; (b) its impact on ultimate consumers is very difficult to assess, thus complicating the task of designing an effective and efficient adjustment for regressivity; and (c) it is not transaction-based, so that it is doubtful that it can be uniformly passed on to consumers and that, for compliance purposes, it will give rise to as good an audit trail as a VAT. Moreover, as the staff options pamphlet notes, the allowance of credits against BAMT liability for income and payroll taxes paid may well be a GATT violation.

V. Opposition to Employment Tax Increases

NAM opposes without exception, and would urge the President to veto, any change that would increase the employment tax burden of either private sector employers or private sector employees. Payroll tax levels are already excessive and contribute significantly to the competitiveness problems of many employers. The unceasing rise of such taxes throughout this decade has, for many employees, completely negated any benefit from the tax rate cuts enacted in 1981 and 1986.

In the case of both FICA and FUTA taxes, there is no demonstrable need to augment the trust funds to which such taxes are dedicated. The temporary 0.2% component of the FUTA tax that will expire after 1987 has fulfilled its purpose and is no longer needed. It should therefore be allowed to expire as scheduled.

The proposed indexing of the FUTA wage base is also objectionable. This change would increase revenues not only at the federal level but also in 17 states and the Commonwealth of Puerto Rico. In many of these jurisdictions the funds would simply be unneeded. In California, for example, the state unemployment compensation system has a surplus of several billion dollars. We believe that additional unemployment taxes should be raised only in response to specific unemployment compensation needs, not in response to general revenue concerns arising out of the federal budget deficit situation.

We express no opinion as to the advisability of extending the Medicare payroll tax to all state and local government employees.

VI. Opposition to Estate and Gift Tax Increases

We oppose without exception, and would urge the President to veto, any change that would increase federal estate and gift tax revenues. Such taxes have an adverse effect upon the capital formation and initiative that are so necessary to industrial activity and the expansion of employment opportunities. Also, the imposition of such taxes often leads to the forced sale and breakup of family-held businesses. Accordingly, NAM's long-term policy objective in this area is to see estate and gift taxes removed entirely from federal use.

We are particularly distressed to see Congress once again considering repeal of the "stepped up basis" rule and other devices for extracting revenue from appreciated assets passing from a decedent. Congress committed a major policy error last year by significantly increasing capital gains taxes on sales or exchanges of assets occurring during a taxpayer's lifetime. It should not further compound this mistake by attempting to tax appreciated property passing at death. In many instances of property held for long periods, the so-called

"appreciation" may be wholly illusory, i.e., the result of inflation, and the property may actually be worth less in constant dollars than when it was originally acquired.

VII. Positions on Miscellaneous Non-Tax Revenue Sources

A number of non-tax revenue increases are under consideration. One of these is a significant increase in the amount of premiums paid to the Pension Benefit Guaranty Corporation. While NAM recognizes that PBGC premiums will have to be increased, we are strong supporters of the concept that such premiums should be risk-related.

At this time, we express no position for or against the concept of raising revenue through the imposition of so-called "user fees."

Similarly, we express no position for or against the concept of increasing receipts through the sale of government assets. NAM has no quarrel with asset sales that can be justified on grounds independent of the need to reduce the federal deficit. It should be noted, however, that the stock of salable government assets is ultimately depletable and, moreover, that each such sale is a non-recurring event that does nothing to remedy the long-term imbalance between revenues and outlays.

VIII. Conclusion

With the sole exception of increased receipts derived from lowering capital gains tax rates, NAM is opposed to any increase whatsoever in federal revenue derived from changes in corporate or individual income taxes, selectively-imposed excise taxes, estate and gift taxes, or private sector payroll taxes.

If Congress is determined to insist on a tax increase, a policy alternative we view as vastly inferior to further spending cuts, then it should only do so by implementing a general consumption tax system designed along the lines discussed in Part IV of this testimony, provided that none of the revenues from such a system are used for additional spending. One significant advantage of such a system which was not discussed in the staff options pamphlet is that it would derive considerable revenue from the previously untapped "underground economy" whenever unreported cash income is spent on "above ground" consumption.

Finally, with the exception of our support for risk-related PBGC premiums, we express no position at this time either for or against user fees, asset sales or other non-tax sources of government revenue.

Mr. Chairman and members of the Committee, this concludes my prepared testimony on behalf of NAM's members. Let me express once again our gratitude for the opportunity to participate in this important inquiry. I would be pleased at this time to take any questions you may have.

Mr. PICKLE. I would thank you, Mr. Huard, and thank all of you, the panel, for your brevity and for your very clear and strong positions. They will be helpful to the committee.

I have two or three questions.

Dr. Rahn, you have recommended the lowering of the capital gains rate to 15 percent. And you have shown by your studies that it would raise a considerable amount of money.

Do you know whether Treasury has made such a study on this subject?

Mr. RAHN. The last study that I know Treasury made was when they first came up with their tax reform proposals. At that point, I know it was the belief of Treasury that a capital gains tax rate of 17.5 percent would maximize revenue. That is why the President proposed at that time to reduce the capital gains tax rate to 17.5 percent.

Since that time, we have had the maximum individual rate tax reduced to 28 percent. Part of the effectiveness, in terms of revenue raising for the capital gains rate, is the differential between the maximum individual tax rate and the capital gains rate. Historically, the capital gains rate has been about 40 percent of the maximum rate, whereas next year the maximum individual and capital gains tax rates will be equal. That is why you are going to see a big fall off in capital gains receipts.

Mr. PICKLE. Have you submitted your studies to Treasury?

Mr. RAHN. Not yet. However, after the comments of the Treasury representative a few minutes ago, you can be assured that I will be over to Treasury this afternoon.

Mr. PICKLE. Well, I believe your position on that then. [Laughter.]

Let me ask Dr. Oswald, I noticed in essence you recommended that we set the top tax rate at 38.5 percent.

Is that a freeze for a period of time, or is that just to make 38.5 percent the rate from now on?

Mr. OSWALD. Mr. Chairman, we believe that it would be more effective to just make that the rate, because the revenue needs would be there for a long time.

Obviously, if Congress feels that that revenue is no longer needed, it could always review the rates. But I think the revenue needs will be there for a long time, and I believe just making that rate permanent, as this committee recommended in the bill that it passed originally would make more sense.

Mr. PICKLE. I thought your testimony had made reference in one instance that there should be a freeze, and in another instance that you'd set the rate.

I take it you're saying that a better rate would be 38.5 and let it be permanent.

Mr. OSWALD. Yes.

Mr. PICKLE. Now, Mr. Huard, you said you were against any excise taxes or any revenue raisers.

As you know, the President has recommended about 10 or 15 different areas, as stated earlier this morning, that would raise some $22 billion over 3 years.

Do you oppose the President's proposal in these kinds of user fees and excise taxes? Do you oppose that?

Mr. HUARD. To the extent that they are tax increases, we oppose them.

For instance, we would oppose the proposed payroll tax increases, whether FICA increases, or FUTA increases. To the extent that they are user fees, we frankly do not have a position one way or the other on user fees, subject to my observation that the Government should not recover more than its cost, and that it should not be a hidden tax—it shouldn't have a profit component.

Mr. PICKLE. Well, then, you wouldn't approve much of the administration's package then, because a lot of that is FICA taxes, payroll taxes, user taxes.

Mr. HUARD. I think it's fair to say on the basis of dollars we would probably oppose 80 to 90 percent of the President's package.

Mr. PICKLE. That's interesting.

Mr. HUARD. It's consistent.

Mr. PICKLE. No, I do not have any other questions. Mr. Matsui, do you have any?

Mr. MATSUI. No, I do not have any.

Mr. PICKLE. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Dr. Rahn, you testified in favor of a capital gains tax, and in your paper you show some range of estimates.

What should the committee do in terms of those? Which of the estimates should we accept?

Mr. RAHN. I think that the range is essentially conservative. If you go through history, the economist who has by far and away the best track record of predicting changes in capital gains revenue as a result of rate changes is Dr. Martin Feldstein. I think the evidence shows that by far and away his model is the best. I would estimate a number close to his.

My own record is one of not being quite as on the mark as Dr. Feldstein. I have been actually more conservative. I might err in that direction again if I was in your shoes, but I would surely come up with a number of at least $6 billion for 1988.

Once again, my record has been one of consistently underestimating the revenue gain from a reduction in the capital gains rate. Dr. Feldstein has been much closer to the target. However, at least my estimates have been in the right direction, unlike a number of the other people who have testified and previously predicted that a reduction in the capital gain rate would lose revenue when in fact just the opposite result occurred in both 1978 and 1981 when capital gains rates were reduced.

Mr. FRENZEL. Well, you cite the Lawrence Lindsey study, but you are working off the low end of that, aren't you?

Mr. RAHN. Yes. Dr. Lindsey has collected the models of a number of the leading economists who have put together estimates on the revenue impact of a reduction in the capital gains rate. I was trying to give the committee what I believe is a responsible range of the amount of revenue raised from a reduction in the capital gains rate to 15 percent without going to either extreme.

Somebody had mentioned a $15 billion number. I think that is extreme, on the high side. Other people have said that a reduction in the capital gains rate to 15 percent would result in no gain in

Federal revenue or even a slight loss of revenue. I think that is ridiculous and extreme on the low side.

Mr. FRENZEL. OK. What do you expect the Treasury will give us for its estimate?

Mr. RAHN. I find the comments of the gentleman from Treasury who testified before me totally baffling. They are in direct contradiction with what the President has said in the past, and are in direct contradiction with what the administration has said in the past. I can only think perhaps he had a lapse of memory. But I will find out this afternoon and will encourage Treasury to make their position known. The empirical evidence is stronger now than when Treasury made their proposal a couple of years ago you will gain revenue from a capital gains rate reduction.

Mr. FRENZEL. And aren't we coasting on those tax receipts right now from people who rearranged their economic affairs in December on the basis of a 20 percent rate?

Mr. RAHN. The numbers are not in. However, it is obvious that the Government had a huge surge in revenue last year as a result of the tax changes made in 1986. Perhaps up to an additional $40 billion in receipts will have been generated as a result of taxpayers realizing capital gains in 1986 before the capital gains rate increased in 1987.

It is also clear that the reverse effect will take place this year with the higher capital gains rate. The capital gains rate has gone up and down a good number of times and we have a tremendous amount of empirical evidence showing that a lower capital gains rate results in additional Federal revenue. I think almost any responsible economist who has really looked at the evidence would have to conclude that probably between 14 and maybe 20 percent on the high side would be the maximum rate that you would want to have if you wanted to maximize revenues from the capital gains tax. Clearly in 1987 we are beyond the revenue maximizing capital gains rate.

I have no doubt if Congress does not act this year, a couple of years from now, when new revenue figures are in, Congress will say oh, yes, we made a mistake and come back and drop the capital gains rate again.

Mr. FRENZEL. Thank you. You suggest military base closings but you do not suggest particular bases. You just took the figure from the Grace report?

Mr. RAHN. Yes. I have had conversations with Congressman Armey and others about this.

We would be supportive of any reasonable study. We realize that all of you are in favor of closing bases in somebody else's district, and we understand that. However, we do think there is a great number of bases which are unneeded, and which the Department of Defense has said are unneeded and could be closed.

Mr. FRENZEL. Thank you. How about your Tax Court suggestion? What do you do, give everybody who thinks they're losing a chance to buy themselves out and let them stay in if they think they're winning?

Mr. RAHN. I know Senator Pryor and a number of other folks have looked at this proposal. Because a lot of these cases have dragged on more than 10 years, there is a belief that many people,

would agree to settle because they are accruing penalties or interest payments, and it is uncertain when many of these cases will be resolved.

We are surely not getting speedy justice if cases drag on for more than 10 years. There was a major change in the tax law this past year, and maybe this is the time to wipe the slate clean, and get rid of this backlog of cases. Most of these cases revolve around what is a tax shelter and what is not, and the law has changed to eliminate most of these tax shelters. The notion is to reduce the backlog in Tax Court cases, bring in the revenue right now, free up IRS agents to do something more productive, and provide taxpayers with swifter justice than we have seen in the past.

Mr. FRENZEL. Thank you.

I would like to ask Dr. Oswald if he favors the proposal of a tax on security transfers.

Mr. OSWALD. Mr. Frenzel, it's one that we have looked at and think that it has some advantages, but have not taken a definite position on it. We would be happy to follow through on the study and let the committee know our position on that issue.

Mr. FRENZEL. Thank you, Dr. Oswald.

You supported the Tax Reform Act, didn't you?

Mr. PICKLE. Mr. Frenzel, may I?

Mr. FRENZEL. Please.

Mr. PICKLE. We would like to have your position. Will you provide that?

Mr. OSWALD. Yes.

[The following was subsequently received:]

The AFL–CIO has taken no position on the taxation of securities' transfers.

Mr. FRENZEL. You supported the tax reform bill?

Mr. OSWALD. There were a number of elements in the tax reform bill that we thought closed loopholes and made the tax fairer. We thought that the drop in the top rate, as resulting from the conference report in the sanction to the House passed rate schedule was too hard to be cut in the progressivity of the tax system.

Mr. FRENZEL. And so you don't feel bound to hold those marginal rates?

Mr. OSWALD. I think that what we're essentially recommending is that the large bulk of the tax rates be held and that the very wealthy, who have received the largest reduction as a result of that reduction, share a little bit of the burden of the needs of the country currently in terms of raising more revenue to meet the country's current crisis.

Mr. FRENZEL. Thank you.

Mr. Huard, you indicated that if there had to be a tax, that it should be some kind of broad-based consumption tax or VAT.

I assume that you are still following your original course urging the Congress to reduce the expenditures rather than to consider a tax, even including the kind that seems least intolerable to you?

Mr. HUARD. That is absolutely correct. Our first line position is that Congress should not raise taxes at all. It should continue to reduce the growth rate of Federal expenditures.

What I did say, and I think you correctly summarized, was that a broad-based general consumption tax system would probably be the

least injurious system if you are going to have to have a tax increase. But we would just as soon you didn't have one at all.

Mr. FRENZEL. Thank you.

Mr. Chairman, my time has expired.

Mr. PICKLE. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mr. Huard, your testimony that you favor decreasing the expenditures, Federal expenditures, does the National Manufacturers Association also support extending that to the defense budget?

Mr. HUARD. It extends to all areas of the budget. We don't think anything should be off the table. Now that also includes Social Security. We don't think there should be any sacred cows.

Mr. COYNE. So the National Association of Manufacturers is on record as supporting defense budget cuts.

Mr. HUARD. No. Oh, no. You know, the use of the word "cuts" is extremely deceptive. The Federal budget has never been cut.

What we are talking about here is slowing down the growth rate, not cutting anything. And we think that in terms of decreasing the rate at which various areas of the budget continue to grow, everything should be on the table.

Mr. COYNE. OK. In addition to those slowdowns in the escalation of spending in the Defense Department, what other areas would you earmark?

Mr. HUARD. I wouldn't earmark any. I would put them all on the table, as I said, including entitlement programs, Federal retirement, Social Security, everything.

Mr. COYNE. Thank you very much.

Mr. PICKLE. The Chair will call on Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I'm somewhat surprised at the terminology we have been using about tax cuts and tax increases, almost implying we have not had tax increases over the years.

According to my sources, total tax receipts for 1980 were $517.1 billion. The 1986 tax total receipts were $769.1 billion. Estimates for 1987 are $842.4 billion, and estimates for 1988, which is the year in question are $916.6 billion.

Now, when you compare $916.6 billion to $517.1 billion, that's about $400 billion of tax increases—$400 billion more of revenue coming in than there was in 1980. So we have not dramatically cut the amount of taxes coming in.

If we break these numbers down, individual income tax reciepts in 1980 were $244.1 billion and are estimated at $392.8 billion in 1988. Corporate taxes were $64.6 billion in 1980 versus an estimate of $117.2 billion in 1988.

Now, those seem to me to be pretty substantial increases in taxes. So the problem has got to be allocation. How are we allocating those taxes? How are we spending them? We are increasing taxes.

Now, if we look at it in an analytical way, I think we're probably taxing incorrectly. When we look at the world economy, we should have some sort of broad-based consumption tax so that we will be somewhat more harmonized or competitive with our trading partners around the world. And I know that the NAM sort of leans in that direction, but I'm wondering about, Dr. Oswald, how your or-

ganization feels about a broad-based consumption tax, such as most of our major trading partners either have or are now contemplating?

Mr. OSWALD. Mr. Schulze, we would be very strongly opposed to a broad-based tax of the type that you describe. A value added tax, we believe, or a general sales tax would be one of the most regressive taxes and would really be the opposite of what the tax reform program theoretically talked about which was to provide Americans with a more equitable tax system, one that didn't allow large groups of people to escape paying their fair share of taxes and would, at the same time, add some progressivity to that tax structure.

Mr. SCHULZE. So I take it, Dr. Oswald, that your concern seems to be more in who pays taxes and how they pay them rather than the ultimate result. Even if a broad-based consumption tax would create 8 million new jobs, that's not of concern, it's a matter of what money is coming in and where we get it. Do I read you correctly?

Mr. OSWALD. Mr. Schulze, there is no example that value added tax creates jobs. If anything, it would, in our belief, curtail jobs because it would tax those people who currently would have lesser taxes because they are lower income people. It would then reduce their ability to demand goods and services and thus reduce the number of jobs rather than increase them.

Mr. SCHULZE. Of course, you know very well there are ways to make almost any taxation system graduated. We can build progressivity into any form of taxation. So even with some progressivity, you would be opposed to that type of taxation?

Mr. OSWALD. Mr. Schulze, it would be very hard if someone were buying an article for the salesclerk to say how much money do you earn, and then ask them to pay a higher tax rate than someone else.

It seems very, very difficult to build into any of the sales tax proposals real progressivity. One can try and make it a little bit less regressive but not progressive.

Mr. SCHULZE. Well, it really could. And sometime when we have time, perhaps we can discuss it. But there are certainly ways to make it progressive.

Dr. Rahn, do you have any thoughts on a broad-based consumption tax which would in effect make our producers more competitive in overseas markets?

Mr. RAHN. Well, clearly a broad-based value added tax has lots of advantages in reducing economic distortion.

Mr. SCHULZE. Let me interrupt you just for a second here, Dick, because I don't think that broad-based necessarily has to be followed by value added tax.

Mr. RAHN. OK.

Mr. SCHULZE. There are other types.

Mr. RAHN. There are many ways of structuring a consumption tax and there are pros and cons on the structuring.

We have to looked at it. Our great fear has been if you instituted a consumption tax, it would be just another level of taxation, and we would end up with higher taxes and higher spending.

As I cited in my testimony, the evidence is overwhelming that since World War II every time the Congress has increased taxes, they have increased spending by more than the amount they increased taxes, and we've ended up with bigger deficits and slower rates of economic growth rather than lower deficits and higher rates of growth.

Until the Congress passes a firm balanced budget amendment I think we will probably remain opposed to a consumption tax.

If you had a firm limit on your overall tax take, then I think we would offer many proposals of how to make the tax system more efficient.

Mr. SCHULZE. How about in place of the alternative minimum tax? It seems to me that would satisfy both Dr. Rahn's problems and Dr. Oswald's problems. He wants to get those people that are not paying taxes. We could use this in place of an alternative minimum tax to guarantee that those people out there in the business community who are not paying taxes will pay taxes.

Mr. Huard, if there was a consumption tax, what type of proposal would you endorse?

Mr. HUARD. Well, as I explained in some detail in my lengthier prepared testimony, as between the two choices outlined in the staff pamphlet, one of which was the traditional invoice and credit method value added tax based on transactions, the other being the subtractive method business alternative minimum tax, we would clearly prefer the value added tax.

Mr. SCHULZE. I thank you.

Thank you, Mr. Chairman.

Mr. PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Let me ask Mr. Oswald, what was the impact of last year's congressional action on tax reform on Americans with over $200,000 in gross income?

Mr. OSWALD. The reports that have come from the studies made for this committee indicated that they received substantial cuts in their taxable income as a result of the tax cuts; that they received the largest proportion of tax cuts, except for the very poor who were totally removed from the tax rolls.

Mr. DORGAN. So, generally, the upper income folks, as a result of last year's tax reform, received a decrease in their tax responsibilities?

Mr. OSWALD. That's correct.

Mr. DORGAN. Let me ask Mr. Huard about a statement that you use.

You indicated that, I believe, the corporate tax rate was 32 percent, 32-33 percent?

Mr. HUARD. Approximately triple the effective personal rate.

Mr. DORGAN. That's at odds with the information provided by the Joint Tax Committee which has provided the same estimates for Congressman Pease and myself over a number of years, which show it to be about half of that level, 16-17 percent effective tax rate.

What would be the reason for that difference?

Mr. HUARD. I have no idea. I would be glad to analyze the way they compute their figure and compare it to the way I compute

mine, and give you a written response for the record, but frankly I think no matter how you analyze it, if you analyze the two taxes consistently, you will find that the corporate effective rate is double to triple what the personal effective rate is, no matter what kind of carve-outs you use.

[The following was subsequently received:]

National Association
of Manufacturers

Government Regulation, Competition
& Small Manufacturing

July 27, 1987

The Honorable Byron L. Dorgan
U.S. House of Representatives
238 Cannon House Office Building
Washington, D.C. 21515

Dear Mr. Dorgan:

I regret that I have not heard from you relative to my request of July 9 for information on how the Joint Committee on Taxation is able to furnish you with calculations alleging that the effective corporate tax rate is around 16 or 17 percent. Because I do not want the record to show I was unresponsive to your request, made when I testified on July 7, that I elaborate on my effective rate calculations, I am furnishing this response for inclusion in the hearing record.

It is estimated that in the current fiscal year, the federal government will collect $105 billion in corporate income taxes on total corporate profits of about $320 billion, and $364 billion in individual income taxes on total personal income of about $3.7 trillion. The effective FY87 rates of federal income tax derived from these figures are 10% and 33% for individuals and corporations, respectively. Based on actual FY86 figures--corporate profits of $299.7 billion and personal income of $3.487 trillion; corporate and individual income tax payments of $63.1 billion and $349 billion, respectively--the effective individual rate was 10% and the effective corporate rate was 21%.

This merely illustrates my point that, even prior to the Tax Reform Act of 1986, the corporate effective rate was already double that of individuals. For the foreseeable future, it will be at least triple that of individuals. I regard my calculations as extremely conservative, as they are based on cash receipts from the federal corporate income tax, not on corporate tax accruals, which is a much larger figure.

I am again regretful that, due to lack of information, I am unable to analyze the difference between my calculations and those of the Joint Committee.

Sincerely,

cc: Robert J. Leonard, Esq.

1331 Pennsylvania Ave., NW
Suite 1500 - North Lobby
Washington, DC 20004-1703
(202)637-3047

Mr. DORGAN. Let me make the point that in a rather serious study that has been done yearly by the Joint Tax Committee, they estimate the effective corporate income tax rate in this country to be 16 to 17 percent.

Mr. HUARD. What do they estimate the personal rate to be?

Mr. DORGAN. I don't have that figure in front of me.

Mr. HUARD. Well, to me that's the relevant consideration, Congressman.

Mr. DORGAN. Well, what's relevant to me is what you assert as the effective corporate income tax rate.

I would like to have you, if you would, see if we can compare that information with what the Joint Tax Committee provides this committee.

Mr. HUARD. The thrust of my point, however, was that the corporate rate is at least double or triple the personal rate.

Mr. DORGAN. Dr. Rahn, I have been interested in your testimony. You have been here many times, and I think you have provided this committee with useful testimony.

In your testimony today, however, your revenue raising options on page 9 include a good many asset sales. And a lot of us look with skepticism on those suggestions, not because they are bad ideas necessarily. There may be instances in which we should engage in some asset sales with assets that are no longer needed. But to use this as the President does, and as I think you do here as a part of the solution to provide income in a situation where we have an expenditure level of somewhere around 24 percent—you probably have the exact numbers—24 percent of GNP and revenues of around 19 percent seems somehow not very thoughtful in the long term.

You know, these asset sales would be a one-time revenue pickup, wouldn't they?

Mr. RAHN. I have two comments on that point.

When we testified before the Budget Committees, we recommended many reductions in expenditures to reduce the budget deficit.

In this testimony, we are trying to respond to the budget resolution. Thus, many of those other suggestions we made in our Budget testimony are somewhat moot to these hearings.

However, asset sales have several advantages over the long term. One, is that a number of these assets could be more productively used in the private sector. You would get better utilization from these assets and ultimately, taxes paid by the private sector owners of these assets resulting in an annual revenue flow to the Government.

More importantly, as a result of these asset sales you not only have a reduction in the level of outlays this year as well as additional revenue, but Federal interest expense will be lower not only this year, but in all succeeding years since the deficit will be smaller than would have otherwise without these asset sales.

It should be noted that the asset sales we laid out were suggestions for this year. Congress could continue to sell unneeded assets in future years to raise additional revenue.

Mr. DORGAN. Yes. But you understand my point. My point is if we have expenditures at a 24 percent level and revenues at a 19

percent level. Let me digress there to say the two biggest expenditures are defense, which I would guess neither of you would countenance large reductions in, and Social Security. In the event we reduced Social Security expenditures, I would guess you would think, and I would probably agree, we would have a responsibility to reduce the amount of revenue we are taking from the paychecks of workers in America to pay for that because it's dedicated revenue.

So there goes half of the Federal budget. But my point is if you have 24 percent and 19 percent, and you seriously want to analyze how do you reconcile that, a lot of us don't think it's a very serious proposal to say, well, you reconcile that by selling off your assets. We call that eating seed corn.

Mr. RAHN. I will send you a copy of our budget testimony where we specifically recommended tens of billions of dollars in expenditure reductions. Unfortunately, the Budget Committee did not use many of our recommendations and, hence, we are left with this bind, and your committee has to raise $20 billion of revenue.

I have submitted a number of revenue raising options within the jurisdiction of your committee to raise the needed $20 billion of revenue. A number of our recommendations would require your committee to change your jurisdictional rules. Our revenue raising options represent a good faith effort to meet the revenue mandate of the budget resolution.

[The following was subsequently received:]

STATEMENT
on
FISCAL YEAR 1988 BUDGET
for submission to the
HOUSE COMMITTEE ON THE BUDGET
for the
U. S. CHAMBER OF COMMERCE
by
Peter M. Flanigan*

February 27, 1987

The relentless growth of federal spending has been the chief cause of rising federal deficits. The frustration over repeated failures to solve this problem eventually led to a strong bipartisan effort that resulted in the passage of the Gramm-Rudman-Hollings amendment. Although some progress has been made, there is still cause for disappointment. Consequently, it is important for Congress to take advantage of the many opportunities for spending reduction and make substantial cuts in projected federal outlays. Anything less than this--and I include tax increases--will be ineffective and will jeopardize the economy's ability to grow.

Less than two years ago, the prospects for deficit reduction seemed grim. The Congressional Budget Office (CBO) had projected a path of rising annual deficits that climbed to over $300 billion by 1991. Today CBO is forecasting a more favorable path for deficits with the 1991 deficit, estimated to be $109 billion.

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*Managing Director of Dillon, Read and Company, Inc., and Chairman of the Economic Policy Committee of the U.S. Chamber of Commerce.

Although federal spending continues to grow, Gramm-Rudman-Hollings has led Congress to take some courageous spending reduction efforts. Congress has made significant reductions in defense spending growth and slowed the growth of nondefense discretionary spending. By avoiding a major tax increase, Congress also has improved the ability of our economy to grow and create jobs.

However, the major source of our deficit problem continues to be the spending side. Spending on major nonmeans-tested entitlement programs continues to escalate. For example, there have been no major attempts to make even modest changes in the Social Security program, such as a one-year cost-of-living adjustment (COLA) freeze. We believe that there are many of spending reduction opportunities in other areas of the budget. These include agricultural price support reform, privatization, program phaseouts and freezes, financial reforms, higher user fees, and fiscal federalism.

Missed opportunities for spending reduction are revealed in CBO's deficit forecast for this fiscal year. They project a deficit of approximately $175 billion, which is $30 billion over the Gramm-Rudman-Hollings target set for 1987. However, much of the overage could have been avoided if, for example, a more responsible farm bill had been crafted last year or if the 1987 budget sequester had been passed by Congress and signed by the President.

The Chamber believes that the President's budget for 1988 provides a useful framework for future budget deliberations. We applaud the President for proposing a budget that meets the requirements of Gramm-Rudman-Hollings with spending reductions and other program reforms. His resolve to avoid tax increases demonstrates his commitment to economic growth and freedom of choice.

However, we believe that the President's budget does not go far enough. For example, managerial efficiencies within the defense department should be pursued. Serious consideration should be given to trimming those "pork barrel" aspects of the defense budget, now that firmer limits are being placed on total defense spending. A one-year COLA freeze should be applied to nonmeans-tested entitlements. The median real income of the elderly has more than doubled since 1950 and, over the last 20 years, has risen faster than that of the nonelderly population. Fundamental agricultural price support reform also should be undertaken, because such spending is now approximately $26 billion or five times greater than the annual average for the 1970's.

I. Federal Budget Milestones

Less than two years ago, our prospects for fiscal discipline seemed rather dismal. At that time, the CBO had forecast an ominous path for federal deficits. According to CBO's official 1986 forecast, the baseline federal deficit was projected to rise to $302 billion by 1991.

Since that time, our prospects for deficit reduction have improved significantly, and much of the former skepticism has been modified. For example, according to the most recent forecast by the CBO, the baseline 1991 federal deficit is projected to be $109 billion. In other words, the projected federal deficit for 1991 has been cut by more than half.

Although we recognize that deficit forecasts are often tenuous and that $100 billion deficits are quite unsatisfactory, much progress has been made. Congress can take much of the credit. One major milestone was the bipartisan

support that led to the passage of the historic Balanced Budget and Emergency Deficit Control Act or Gramm-Rudman-Hollings (G-R-H) and the much needed discipline that this legislation has injected into the federal budget process.

Congress has achieved savings by slowing defense spending growth, achieving economies in the nondefense discretionary portion of the federal budget, and enacting, in 1986, an $11.7 billion across-the-board sequester mandated by G-R-H. Other changes include termination of the General Revenue Sharing program, legislation enabling the sale of Conrail, substitution of housing vouchers for construction subsidies, and reduction of the Amtrak subsidy. As a consequence, federal spending growth has declined from its 10% average annual growth rate, between 1980-1985, to 4.6% in 1986.

In attempting to meet the G-R-H deficit targets, Congress has been wise in avoiding a significant tax increase. This has helped contribute to the third longest recovery in postwar history, which has created 11.1 million new jobs.

II. The Challenge Continues

Although Congress has begun to make some progress, much more needs to be done, particularly now that we are in striking distance of a balanced budget. In developing a budget resolution for 1988, it is important for Congress to continue to make substantial progress against federal spending.

The Chamber believes that the public prefers such a federal budget policy--that the public perceives that reducing the government's share of the national economy places more control over resources in its own hands. We believe that the public understands that such a policy enhances economic incentives, the role

of the entrepreneur, and job creation and that such goals are fostered by policy of limited federal spending and moderate taxation.

In spite of recent budget economies, the fact is that the federal government has been a "growth industry." For example, federal spending as a percentage of Gross National Product (GNP) stood at 20.5% in 1979 but has advanced to nearly 24% in 1986. The obvious implication is that federal spending has grown faster than the growth of the economy. Since 1980 the real growth of federal spending has averaged 3.7% annually, much more than the real growth of the economy, which averaged 2.4%. Even during the first full year of G-R-H, 1986, federal spending grew slightly faster than the growth of the economy. In fact, if we extrapolate the modern historical trend of federal spending, federal expenditures as a percentage of GNP will approach 40% by the late 1990's, a level that will match the current high levels associated with many stagnant European countries.

Moreover, our deficit problem has not been due to a dearth of tax revenues. Today, tax revenues as a percentage of GNP (18.6%) are consistent with the long-run average. Since 1980 tax revenues have increased by $253 billion, an increase of 49%. However, federal spending has increased more, rising by $399 billion, an increase of 67%. This suggests to us that government spending is the chief cause of the deficit and that better control over outlays is the only solution.

III. Opportunities to Reduce Spending Growth

The opportunities for spending reduction have been well-known for a long time. Moreover, these cases are not instances of cutting programs for the sake of simply cutting the budget. Most of these are in programs that do not always

meet critical national objectives or programs that are inequitable, inefficient, extravagant, or more appropriate for lower levels of government or the private sector.

Nearly every portion of the federal budget contains areas worthy of consideration. A veritable "bank" of these recommendations has been compiled by the CBO, the General Accounting Office (GAO), the Office of Management and Budget (OMB), the Heritage Foundation, the Brookings Institute, the Grace Commission, the Senate Committee on Finance and the U.S. Chamber. Together, they comprise spending reduction opportunities that exceed $100 billion in one year alone. A general outline of some of the key provisions is sketched below.

o Federal Retirement Reform Entitlements for the elderly, including Social Security, Medicare, and Civil Service pensions, have been the fastest growing component of the federal budget for the past 20 years, growing from $25 billion in 1966 to $317 billion in 1986 or from 18.5% of the federal budget to 32% today. The Grace Commission has estimated that today's retiree who lives a normal lifespan receives Social Security benefits of at least three times the combined value of employee-employer contributions plus interest. This translates into a real return on Social Security investment to current retirees that can range between 9% and 20%, depending upon the year of retirement. The next generation will not fare so well. They confront greatly increased Social Security taxes. According to some estimates, today's 20-year-old will receive 72 cents for every dollar that he contributes to the Social Security system. Civil Service and military retirement systems contain an even higher subsidy rate. Consequently, it is important that Congress implement reforms, such as a one-year COLA freeze. CBO also recommends further economies, such as limiting

the increase in Social Security bend points and reducing benefits for federal workers who retire early.

The Medicare program also badly needs reform. The program originally was estimated to cost $4 billion by 1980. It actually cost $32 billion that year—an eightfold increase. Today, such expenditures are $70 billion. Even modest subsidy reductions can yield substantial savings. For example, according to estimates by the CBO, if Medicare premiums for physician services were raised so that individuals receive a 50% insurance subsidy instead of the current 75% subsidy, over $3 billion could be saved in 1988.

o Agriculture Reform There are few areas of the budget where so much has been spent and so little accomplished. Price support payments have vaulted to $26 billion in 1986, the highest in the history of the program. This is significantly different from the 1970's when annual outlays seldom exceeded $5 billion. Yet, the plight of the farm sector has worsened.

One major problem is that a great portion of these payments, over 40%, goes to the largest 15% of all farms, which have net incomes that exceed $75,000 a year. Even more bewildering, taxpayers have to pay farmers to cut production through acreage reductions, paid land diversions, and payment-in-kind programs. Even modest reforms, such as means-testing price support payments, could save in excess of $7 billion annually. A more effective approach is to phase out such subsidies and provide assistance for marginal farmers to find other opportunities.

o Fiscal Federalism The approach here is to return greater funding responsibilities to lower levels of government for local public goods. This

would go far to reduce the cross subsidies that are involved when residents in one part of the country are forced to pay for programs that primarily benefit residents in a different location. It makes sense for lower levels of government to pay for such programs, because they generally run a budget surplus while the federal government confronts large deficits.

Such proposals as increasing the local match on federal funds, from its current 50% level, in mass transit could save billions. According to estimates by OMB, from 1970 to 1980 the use of public transit decreased from 8.9% to 6.4% of total work trips taken, yet federal subsidies grew by 2,150%. Rarely have so many paid for the benefit of so few.

o Privatization Congress should also take advantage of a relatively novel method to achieve spending reduction--privatization. The advantage of privatization is that public programs are not eliminated but shifted to the private sector. Privatization can take many forms, such as the sale of public assets and commercial activities to private interests, contracting out, and the use of vouchers. The President's 1988 budget, for example, includes nearly $6 billion in privatization initiatives and much more is possible. Great Britain's recent experiment with privatization has added over $20 billion to its treasury.

o Cost Shifting This approach shifts the cost of federal programs to individuals who presently receive large subsidies by using federal services. Examples include higher Coast Guard user fees, auction of the unassigned broadcast spectrum, greater fees for the use of inland waterways, and higher fees for recreational services.

o Defense Reforms Further defense savings can be achieved through managerial efficiencies, reduction of ineffective weapons systems, and the many recommendations by the Grace Commission, GAO, and CBO. For example, Congress should give serious consideration to the closure of unnecessary military bases and reform of the commissary system. The Grace Commission has estimated potential savings from these sources to be nearly $3 billion.

o Other Programs Reforms The federal budget is composed of many moderate sized programs. This has prompted some to say that the federal budget is a "Leviathan composed of Lilliputians." Nevertheless, spending reductions summed over this area can amount to a significant savings. In fact, simply freezing the nondefense discretionary portion of the budget, where most of these programs reside, could result in over $10 billion of deficit reduction in 1988.

Congress should consider some of these opportunities. For example, the Rural Electrification Administration still makes loans to rural electric cooperatives at the bargain rate of five percent. Until 1973 it made those loans at two percent. Amtrak revenues only cover 58% of operating costs, and the Amtrak subsidy amounts to over $30 per passenger. Many higher education loans and grants are made to students whose parents income is substantially in excess of the median income. The Maritime Administration's cargo preference program raises government shipping costs by $200 million annually.

o Financial Reform Finally, Congress should consider such reforms as loan asset sales. This would serve the goal of making apparent the huge subsidies imbedded in the $1 trillion dollar federal loan portfolio, thereby curbing program abuse. These sales also would produce a large increase in cash flow to the federal government. This can help meet short-run deficit goals at

the same time that substantive program reductions are making cumulative reductions in out-year budget deficits.

The survey above is only a bare outline of the possibilities for spending reduction. Congress only needs to reduce the 1988 current services budget by approximately 4.5% to reach its deficit goal. We believe, in light of the opportunities delineated above, that this is a small price to pay for benefits obtained through a sound economy.

IV. Looking Toward the Future

As we look to the future, we must realize that reducing federal spending also has an important human dimension. For years we have been told that more public spending would solve social problems. More public spending was hypothesized to result in greater employment and to provide opportunities for the less fortunate.

However, mounting evidence from around the world suggests that we have gone beyond the point where spending could be helpful and are now in the range where serious problems have emerged. It suggests that more public spending has resulted in higher unemployment, slower economic growth, and diminished opportunities for all. For example, Europe in the 1960's and early 1970's boasted brisk economic growth. From 1965 to 1974, the Western European governments spent an average of 37% of their GNP and economic growth stood at 4.3%. However, government spending continued to accelerate from 1975 to 1984, rising to 47% of GNP and economic growth slowed to a paltry 1.8%. In human terms, the Western European economies suffered dramatic increases in their unemployment rates, averaging a stunning 152% increase in that 10 year period.

The National Chamber Foundation is now embarking on a comprehensive study of this issue.

The emerging lesson is that, beyond a point, more public spending is dangerous to our economic health. The implication is that with more public spending there is a greater likelihood of establishing ineffective programs--programs that create more problems than they solve. And just a cursory review of the U.S. federal budget uncovers many such programs.

As a consequence, it is important for Congress to consider the human costs of wasteful federal programs--the net job loss and loss in economic growth associated with more spending. Such an assessment would allow Congress to separate the useful programs from those that are ineffective and inefficient.

Treating federal programs in this way can improve the human condition. Reducing expenditures on wasteful programs releases society's resources for more productive uses. This increases the net wealth of society through job creation and economic growth. Reducing such expenditures also makes it possible to achieve moderate levels of taxation. This allows us to avoid the tragic human maladies that are associated with heavily taxed societies, such as chronic unemployment and economic stagnation.

V. Staying the Course and the President's Budget

The Chamber believes that Congress and the President during the past two years have chosen the correct course in attempting to meet G-R-H deficit targets through spending reductions. It should continue the same course of reducing federal spending growth and avoid significant tax increases.

In our opinion, robust economic growth is a major prerequisite for deficit reduction. For example, according to estimates by CBO a 1% increase in real economic growth would lower the baseline federal deficit by $61 billion in 1991 — the last year of G-R-H. As a consequence, we must make sure that we do not have a major tax increase, an action that surely would dim our prospects for economic growth and deficit reduction.

We should realize, by now, that a large tax increase may not reduce the deficit and may worsen it by diminishing economic growth. Unfortunately, the disincentive effects of taxation are rarely accounted for in budget analysis. However, these effects are important when one considers that higher taxes mean less growth, less income, smaller profits and, therefore, a smaller tax base. Moreover, higher taxes usually lead to more spending.

The major tax increases of this decade illustrate this point. The Tax Equity and Fiscal Responsibility Act (TEFRA) promised a $103.9 billion deficit in 1983 and an $83.9 billion deficit in 1984. These targets were never achieved, because the rate of growth of tax revenues actually fell and federal spending exceeded the budget resolution by a substantial margin. A similar experience occurred in 1984 in conjunction with the Deficit Reduction Act. Taxes were increased, but again the rate of growth of tax revenues fell and federal spending growth rose by nearly 10%.

Unfortunately, some are suggesting that we go in the same direction. They have proposed that the full implementation of the marginal rate reductions be delayed. However, we know from the experience of Economic Recovery Tax Act (ERTA) that delaying such tax rate cuts depresses economic activity until the reduction is fully implemented. Moreover, the 1987 transitional rate structure

is not low enough to compensate for the economically damaging changes in the tax base, such as repeal of the investment tax credit, scaled back capital cost recovery allowances, and reduced capital gains exclusions.

A similar prognosis applies to other recent tax proposals. For example, one popular proposal is an oil import fee. However, econometric simulations by well-respected groups, such as Data Resources Incorporated and Wharton Econometric Forecasting Associates, document severe negative effects from higher oil import fees. They show that higher prices of oil lead to sharp reductions of economic growth and significant job loss.

For these reasons, the Chamber supports the goals of the President's 1988 budget. We applaud its resolve to reduce the deficit with spending reduction and to avoid tax increases. We also appreciate its awareness of the opportunities available for spending reduction. The administration has chosen some innovative and effective strategies for deficit reduction. These include privatization, increased user fees, agriculture reform, financial reforms, fiscal federalism, and phaseouts of inefficient programs.

Nevertheless, we believe that the President's budget can be improved. We believe that it is essential to go further in such areas as defense, Social Security, agricultural subsidy reform, and other entitlement programs. The inclusion of these items will create a greater sense of equity and shared sacrifice.

The Chamber is encouraged by the progress made in the last two years. We applaud the determination of many in Congress to pursue a deficit reduction strategy that relies entirely on spending restraint and other federal program

economies. We recommend that Congress continue along the same course in the preparation of the 1988 federal budget. The benefit will be a future of sustained economic progress.

Mr. MOODY. Would the gentleman yield for one second?

Mr. DORGAN. I would be glad to yield.

Mr. MOODY. There is an important difference, isn't there, Dr. Rahn, between selling financial assets and selling tangible assets. With tangible assets, Amtrak, military bases, petroleum, what have you, you have an argument. You can argue pro and con. And I think often there's a strong argument to be made one way or the other.

But financial assets, selling financial assets which in turn yield revenues to the Government in succeeding years, is exactly like printing more bonds. It has identical financial and economic impact.

Mr. RAHN. If you take a look at the default rate on many Government financial assets, you will find a very poor collection rate. If these assets are sold to the private sector, you will tend to see much higher collection rates and additional tax revenues to the Government.

The Government just has not managed many of these financial assets very effectively. The main argument for selling these assets is more effective management in the private sector, not the fact you get a particular amount of revenue in one year.

Mr. DORGAN. Mr. Chairman, might I ask one additional request of the witnesses?

I would like to ask if the witnesses would provide me with whatever internal analysis they have of the tax rates of our major competitors and the tax features of the tax systems of our major competitors so that we might analyze that. The reason I ask the question is that last year, during tax reform, I spent a fair amount of time trying to analyze what type of tax structure Japan has with respect to its corporations? What type of structure does West Germany, England, Canada, and other countries have with respect to their corporations?

The competitiveness issue is not one that we should ignore. At the same time, the information that I had all of last year suggested that many of the other countries who are major competitors, and successful ones at that, had a much heavier rate of taxation on their corporations than we did.

But I would like to see the information you could compile for the committee on that basis.

Mr. RAHN. Do you also want to see how our competitors tax capital gains and savings?

Mr. DORGAN. Absolutely.

Mr. RAHN. A lot of these things are tradeoffs. Japan, for instance, excludes capital gains from taxation, though has higher marginal rates than the United States.

[The following was subsequently received:]

COMPARISON OF INDIVIDUAL TAXATION OF CAPITAL GAINS ON PORTFOLIO STOCK INVESTMENTS IN ELEVEN INDUSTRIALIZED & SIX PACIFIC BASIN COUNTRIES

INDUSTRIALIZED COUNTRIES

Country	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Period to Qualify for Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
United States (A)	38. 5%	28%	More Than Six Months	None
Australia (B)	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada (C)	17.51%	17.51%	None	None
France (D)	16%	16%	None	None
Germany (E)	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan	Exempt	Exempt	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden	45%	18%	Two Years	3%
United Kingdom (F)	30%	30%	None	None

* State, provincial and local tax rates not included.

PACIFIC BASIN COUNTRIES

Country	Maximum Short-Term Capital Gain Tax Rate*	Maximum Long-Term Capital Gain Tax Rate*	Period to Qualify for Long-Term Gain Treatment	Maximum Annual Net Worth Tax Rate
United States (A)	38.5%	28%	More Than Six Months	None
Hong Kong	Exempt	Exempt	None	None
Indonesia	35%	35%	None	None
Malaysia	Exempt	Exempt	None	None
Singapore	Exempt	Exempt	None	None
South Korea	Exempt	Exempt	None	None
Taiwan	Exempt	Exempt	None	None

* State, provincial and local tax rates not included.

Mr. PICKLE. The Chair recognizes Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

I would like to commend our panel. Raising revenue is a difficult subject. All of them have come with positive proposals for us, and I think it is most helpful in the committee's deliberations.

I would like to address my first question to Dr. Oswald and Bob McGlotten, if I could.

In fact, when I used to work for a living a few years ago, I had some contact with a packing plant, and wages at the plant, in the processing plants we were involved with were decent, in the neighborhood of $13 an hour, $13.50 an hour when you count fringe benefits. Obviously less than that when you look at only the stated pay rate.

But we ran in—this would be the late seventies—to a situation where when folks would have a chance to work overtime if they wanted to, a discretionary decision, we ended up having a larger and larger group of them indicate they simply couldn't afford to. And what they were saying was that their marginal tax rate had gotten to the point that with State, Federal, Social Security and some of the other deductions, they were at a point where there simply wasn't much incentive for working men and women to work more, or at least it was a difficult decision for them.

I guess, with your experience, I'd like to inquire, for working men and women who find themselves in those kinds of difficult jobs, do you observe a point where taxes can get so high, they act as a disincentive to productivity and to work? If you've observed that or haven't, if you have observed it though, at what level, at what percentage do you find that has an impact?

Mr. OSWALD. Well, Mr. Brown, I think that most workers are looking for something else than necessarily working overtime. They do have family commitments. The daughter is getting married. They want to go to that wedding. They don't want to work overtime.

The questions are varied. The meat packing jobs that you're talking about, they are very grueling, taxing jobs. They take a very heavy toll for 40 hours, an almost impossible toll at 60 hours. And nobody can really take that sort of pressure week after week after week.

In most cases, we have not found that taxes are the primary element. But it's the physical demands, the social demands and the other elements that are much more a question of whether one can work an additional Saturday or not.

Mr. BROWN. Doctor, let me suggest I agree with your observations about the industry. I guess my question is whether we are talking about auto workers or packing plant workers or whoever, is there a point at which you find the tax incentives become disincentives for people to work?

Mr. OSWALD. Not in the range we are talking about or even at 50 percent and if you take the time and a half that you were talking about, you would have an effective tax rate that would still allow that person, even if they were in the 50 percent tax rate bracket to be earning more per hour at work. Let us assume that they were making $10 an hour. The overtime rate would be $15 an hour. At a 50 percent tax rate, they would be earning $7.50. On the first $10

an hour, they would only be earning $5 an hour, so they would still be earning 50 percent more. So that the tax rate, that marginal tax rate, does not determine whether they work overtime or not. All people are working in order to earn a living and it is not that marginal tax rate that determines whether they work an additional hour or not. It depends upon what their earning capacity is and what their needs are.

Mr. BROWN. Correct me. Am I hearing correctly, your thought is that the tax incentive is not the discouragement for work, as long as it is not above 50? Am I suggesting some things there that——

Mr. OSWALD. I am saying that in the range we are talking about, it may have been a discouraging fact when we had 91 percent. Clearly, 70 percent did not seem to be a discouraging factor in that whole period until 1978, I must say that when I look at last year's reports for chief executive officers in the United States which show earning increases of 17.9 percent, as reported by Business Week, I am shocked at that sort of increase when we still had 50 percent tax rates for top executives.

Mr. BROWN. That is almost as high a percentage as Congress gets. Dr. Rahn, comparing our tax system with our foreign competitors, do you find us at a disadvantage in producing products in a competitive world market because of our tax system and the total amount of tax and the way we apply it? Or do you find it as an advantage?

Mr. RAHN. I think we have some clear problems, one being capital cost recovery where the changes made in the Tax Reform Act clearly put us at a competitive disadvantage. For instance, Canada's capital cost recovery system essentially is the present value equivalent of expensing. If a company were located in Michigan and had an auto parts factory and were deciding whether to open a new plant in Canada or one in the United States, the company would have a great incentive to open the plant in Canada because the capital cost recovery provisions are so much more favorable than in the United States. On the other hand, for certain types of research and development and highly paid individuals who have special skills, as a result of our reduced marginal tax rates, which are highly desirable, the United States has become a more attractive place to work than a place like England or some other countries that still have very high marginal tax rates. I think what you are finding is that in manufacturing, and particularly heavy manufacturing, the United States is at a disadvantage. In certain types of services and communications, the United States may have somewhat of an advantage at the moment, which I look at as desirable. I would like the United States to have an advantage across all industries.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. PICKLE. Thank you, Mr. Brown. Before we proceed, the Chair would like to make the announcement that it is the intent of the committee to proceed through the lunch hour. We have three other panels to hear today. The last two panels consist of five panelists each and they represent some of the largest businesses or corporations or entities in the country. So the Chair would like to announce that we will continue through the lunch period and I also would ask the cooperation of the members to be prepared and to

stay within the time limit. For the next question, the person to be recognized would be Mr. Moody. Mr. Moody.

Mr. MOODY. Thank you. Dr. Rahn, I was intrigued by your opening statement that whenever Government raises taxes, spending goes up. Are you sure the causality might not be reversed? That spending goes up and therefore, Government needs to raise taxes? I mean, you cannot make a statement like that as a responsible social scientist without controlling for, let's say, military activity, international affairs and, of course, domestic demand for spending that may precede the taxes.

Mr. RAHN. There have been a number of studies done by academic researchers. The one I referred to was the Vedder-Gallaway study made for the Joint Economic Committee, which was just published this past year. They are responsible economists, and social scientists, and they studied the causal relationship between tax increases and increased Government spending. A number of other economists have studied this relationship, and it appears that since World War II, increases in taxes have fueled additional increases in spending. Of course, we all know these things are terribly hard to prove with 99 percent level of confidence, but the evidence, from a number of responsible academics has been clear that higher taxes have fueled increased spending. Just as an anecdotal piece, I will give you the 1982 example. In 1982, as you remember, the President was under the impression that leaders of Congress had promised $3 of spending growth rate reduction for each dollar of tax increase. Even the information from Congress is that at a minimum, spending went up $1.26 for each dollar of tax increase in 1982.

Mr. MOODY. Excuse me for interrupting you. Did the President's understanding include military spending reductions?

Mr. RAHN. Yes. I think that was total spending.

Mr. MOODY. Because he didn't propose any military spending reductions.

Mr. RAHN. No.

Mr. MOODY. Well, I will let——

Mr. RAHN. If we look at the statements of then Budget Director Stockman, the anticipation was of the budget deficit going way down. The deficit, of course, soared. This is because the rise in domestic spending during this period has been quite considerable.

Mr. MOODY. My point only is that frequently people feel there has to be more spending for addressing current problems, whether it is solving poverty, going to war in Vietnam, or Korea and what have you; and then they raise taxes accordingly, rather than the other way around.

Mr. RAHN. I know a number of the people at the Public Choice School over at George Mason University, have looked at this, too. And I think there is an increasing belief that large deficits have served to hold down somewhat the growth in spending and that when Government has a surge in tax revenues, this has tended to fuel spending. But there has been a lot of debate in the academic community, obviously, about this.

Mr. MOODY. Obviously, it is very contentious. Obviously, demands for spending can then produce demands for spending as well as revenues. You do not address that side of it.

Mr. RAHN. I administer the National Chamber Foundation and we have some studies underway looking at the relationship between Government spending and economic growth. We have been doing both time series studies in the United States and other countries and cross-sectional studies between countries, and it is very evident that, beyond a particular point, increases in Government spending slow down economic growth for the reasons I detailed in my testimony and that the high growth countries and high growth time periods tend to be associated with lower levels of total Government spending while high levels of Government spending tend to be associated with low levels of economic growth.

Mr. MOODY. Well, I would be interested to see that. It would have to control for a lot of cultural and other variables, such as savings rates. One only has to look at Japan or Canada even—a tremendously different situation.

Mr. RAHN. Let us look at Japan. We have noticed a very definite slow down in Japan's rate of economic growth as government spending has increased as a percentage of GNP. Now Japan's Government spending is approaching our level of Federal spending and their economic growth rates have been no better than ours in the last couple of years.

Mr. MOODY. Well, I think there are many reasons for these effects.

Mr. RAHN. Clearly, in economics, it is always hard examing anything in isolation. However, we have a sufficient body of evidence over time and across countries to make this assertion quite credible.

Mr. MOODY. As a counter-example right here at home, lets look at 1981, where taxes came down and spending went up. Taxes did not go up followed by increased spending. Taxes went down and the spending went up. In 1981, we increased spending, so obviously, there are plenty of counter-examples. Let me switch to this year's problem. Once we have cut spending as much as we can, and I agree with you and probably all three panelists that there are probably areas of the Federal Government where we should cut more spending, but have cut spending as much as politically possible, to reach the objectives reflected in the congressional budget resolution, you must recognize that the President's proposal for different spending cuts got less than 30 votes. By a margin of 5 to 1 of his own party voted against him.

I would like you and your colleagues to just quickly give me an estimate of what will be the effects, by way of negative financial market reaction and higher interest rates, on the economy of failing to meet our target budget deficit reductions of some $36 billion. It seems to me that if we do not meet that target, because we say taxes are bad or what have you, that we are going to pay taxes in another form. In the form of higher interest rates through the financial market reaction. The financial markets seem to be poised, waiting to see if we are really going to reduce our deficits.

And if we do not reduce our deficits and we have not cut spending as much as we can. And if we do not reduce the deficit enough to meet our targets, in my judgment, and I would appreciate your reaction, the financial markets are going to punish us with higher interest rates. Those higher interest rates, even if they go up a rel-

atively minor amount, will swamp any kind of taxes we are looking at, with a consequent impact on employment, capital formation and everything else. So the option is really taxes or no taxes. The option is we are going to pay for this process through the front door, with explicit taxes or do we want to pay it through the back door, through higher interest charges. And that, it seems to me, are the choices we have to face.

Mr. RAHN. If you examine the empirical evidence, there is no relationship between deficits and interest rates. The deficit was getting bigger when interest rates were falling. You can lag it or lead it. The primary determination in interest rates is inflationary expectations, which gets into growth of the money supply. Where deficits are bad, of course, is they do crowd out private sector investment and they do slow the rate of economic growth. The question you must ask yourself with any particular tax increase, knowing that all tax increases end up slowing economic growth, is whether this tax increase is going to be more or less destructive than any real change in the deficit resulting from the tax increase. History shows us that Congress tends to increase spending after taxes are increased, resulting in a larger rather than a smaller deficit. Let's assume for the moment, you reject that notion, and believe that Congress will not increase spending.

Mr. MOODY. Well, it is locked in now for 1988.

Mr. RAHN. That is correct. The projections of revenues coming in from tax increases always tend to be overstated because the Government uses static analysis rather than adjusting for the fact that people will shift their consumption, work investment and saving patterns in response to a tax increase. Assuming you adjust for all that, you must demonstrate that the increase in the deficit is more destructive than the increase in the particular tax. It would be clear that the reduction in saving and investment resulting from a tax increase would be, I think in all cases, more economically destructive than an increased deficit. If you had a pure consumption tax increase, you might be able to argue, neutralizing all these other facts, that would be less destructive than a slightly larger deficit. I think there is a lot to be proved before you get to that point and since it is clear to me that higher levels of Government spending are destructive, that is why we put so much emphasis on reducing the growth rate of spending.

Mr. MATSUI [presiding]. Mr. Levin will inquire.

Mr. LEVIN. Dr. Rahn, on the first page of your testimony, you express your dismay about the disturbing manner in which the discussion is preceded and then you say, we find ourselves debating tax increases on the merits of their progressivity, their acceptability, even their disguisability. Lacking from this debate has been any meaningful discussion over what makes good tax policy. Is progressivity irrelevant to tax policy?

Mr. RAHN. It is not irrelevant but, I think, at times, too much emphasis has been put on progressivity and what you have ended up doing is slowing economic growth.

Mr. LEVIN. But it is not irrelevant?

Mr. RAHN. No, it is not irrelevant.

Mr. LEVIN. All right. Because your statement here would seem to indicate that it is. I mean, you just read——

Mr. RAHN. I think there is too much political emphasis on progressivity and not enough emphasis on the economic growth effects of any particular tax change. Those of us in this room are not the ones who become unemployed when we slow economic growth. It is the people at the bottom of the income scale who are the ones hurt most of all by highly progressive taxes which end up being economically destructive.

Mr. LEVIN. Well, I understand. I may not agree with the precise nature of your statement but the chambers are sometimes described as being uninterested in how the tax falls, the progressivity of it and I must say as I read this, your juxtaposition of comments I thought, maybe inadvertently, gives credence to the belief.

Mr. RAHN. We believe a tax system ought to maximize economic growth and economic opportunity and there are many provisions in our Tax Code now which do not maximize economic growth. Those provisions in our Tax Code which slow economic growth always most adversely affect the people at the bottom end of the income scale.

Mr. LEVIN. Maximize economic growth, but with some relationship to the progressivity of the tax?

Mr. RAHN. If it is not destructive to economic growth and economic opportunity. Clearly the notion of ability to pay is relevant in good tax policy.

Mr. LEVIN. Okay, let's just leave it at that then because I think that statement clarifies your testimony, at least to some extent. What about cutting the capital gains tax to 10 percent? Have your studies shown what would happen?

Mr. RAHN. I believe you would have a revenue loss in the short run by reducing the capital gains rate to 10 percent. There may be a long-term case for eliminating capital gains taxes altogether, at least for most people, as the Japanese and many others have done. This is because the capital gains tax tends to be destructive to the ability of companies to raise venture capital. In terms of just the revenue effects in the short run, I think a rate much lower than 15 percent would begin to lose revenue. I believe the relevant question is what rate of capital gains taxation, in the short run, given the deficit and revenue problems, would maximize the tax revenue from the capital gains tax? It is clear that the 28 percent rate is too high and does not maximize revenue from the capital gains tax.

Mr. LEVIN. Okay. On your Tax Court proposal, I must admit I am a bit mystified as to how it would work. Everybody with a matter before the Tax Court would pay a fixed percentage, regardless of the nature of the case. Would you apply that just to cases presently before the Tax Court or those in the future?

Mr. RAHN. The proposal, first suggested by Senator Pryor, would only deal with cases that have already been before the Tax Court and maybe even before the Tax Reform Act of 1986 was passed, as a one time arrangement. Obviously, if you extended that into the future, there would be endless problems with people deliberately engaging in some kind of evasion figuring they could settle their disputes for $0.50 on the dollar.

Mr. LEVIN. Right.

Mr. RAHN. I think the administrative problems would be high but the Government could get a great deal of revenue from this

proposal and when I hear that many of these cases have been in court for 10 years, that just seems an outrage in terms of speedy justice.

Mr. LEVIN. Mr. Huard, let me ask you about the NAM position. Have you publicly criticized the President's proposals in press releases and the like? You said you opposed, NAM opposes 80 percent, in terms of the revenues. Have you been actively opposed to the President's proposals?

Mr. HUARD. We have taken no position at all on the President's budget.

Mr. LEVIN. If you are opposed to 80 percent, why have you taken no position?

Mr. HUARD. Well, as someone has already pointed out, the President's budget did not receive a great deal of votes and frankly, we did not take a position because we did not think that the President's budget was going to go anywhere, to be perfectly candid.

Mr. LEVIN. But the revenue—we are now arguing about the revenue portions and they are very much alive and enough so that a gentleman from the Treasury Department came here alive and, I think, well, and urged their adoption. It is a serious question, because we need a serious debate. You called them tax increases. The President says he would veto any tax increase. I do not know why you do not join the dialog on taxes.

Mr. HUARD. Pardon me?

Mr. LEVIN. I mean, join the dialog by opposing, stating your opposition no matter who is proposing them.

Mr. HUARD. I just stated it. Frankly, we were scheduled to testify before the House Budget Committee in February and if asked that question, I would have expressed the opposition at that time. That hearing was cancelled so members could attend a funeral on the west coast and it was never rescheduled. It is not my fault.

Mr. LEVIN. I do not think that a hearing is the only way to express one's views in society. My time is up. I was going to ask Mr. Oswald and Mr. McGlotten if they would comment, and I guess maybe you can do it in writing, on your proposal about capital gains at death, that loophole as you put it, and how you would handle an area like agriculture. What you do about family farms that pass from generation to generation.

Mr. OSWALD. We would essentially tax them only when they are sold, not at the time of death itself, so that when the son sells the farm, then the tax would be collected.

Mr. LEVIN. Well, let's talk about that further.

Mr. OSWALD. We will respond in writing.

[The following was subsequently received:]

The AFL–CIO supports efforts to include capital gains transferred at death in the individual's income tax. As to family farms and other situations where payment of the tax could create a hardship situation we believe Congress could draft special rules—like those that apply in the estate and gift tax—to establish an installment payment period.

Mr. LEVIN. Thanks very much, Mr. Chairman.

Mr. MATSUI. Mr. Downey for inquiry?

Mr. DOWNEY. Thank you, Mr. Chairman. I just want the witnesses to react, if they would, to the idea that the Budget Committee would want to enact a reconciliation, the sequestration portion

of reconciliation, with a trigger, if the deficit targets were not met. How would the three panelists react to that?

Dr. RAHN. Did I understand you correctly that if it were put in a sequestration?

Mr. DOWNEY. Put back the trigger in sequestration.

Mr. RAHN. We would be in favor of that.

Mr. DOWNEY. You would be in favor of that?

Mr. RAHN. Yes.

Mr. DOWNEY. How about you, Mr. Huard?

Mr. HUARD. We would be in favor of it.

Mr. OSWALD. We would be opposed to it. It would really remove the whole question of policy, which this committee has been asked to do by the Budget Committee. I want to just say that we destroy various programs because this committee does not provide the sort of revenue that the Congress voted for in the budget resolution. To somehow substitute some other mechanism seems to us to be abdication of the responsibility of this committee.

Mr. DOWNEY. Thank you very much. I have no further questions.

Mr. MATSUI. Mr. Stark?

Mr. STARK. Mr. Oswald, I am somewhat distressed. We are constantly advised of the need to increase, raise capital in this country to provide jobs. In this morning's Washington Post, there was an article by David Gordon of the Los Angeles Times, who says that the basis for the newly industrializing countries growth has been their productivity gains, not their wage advantages and, while those countries invested in expanding industries, we sat on our hands and while their governments took out entrepreneurial risks, the U.S. Government poured billions into Star Wars, rather than in productive plant equipment. We have people telling us that is what we should be doing and you want to tax capital gains at death. And the National Association of Manufacturers tells us that, in addition to making rich kids richer, that will cut down on capital formation. Why are you against capital formation, Mr. Oswald?

Mr. OSWALD. Mr. Stark, I am not against capital formation. I just think that everyone should pay their fair tax. A very interesting report from U.S. News & World Report recently showed that the richest families had very big increases in their assets last year. The richest by over $1 billion. That money they got was for doing nothing except clipping coupons and seeing their stocks go up. If that is tax justice, I do not understand what tax justice is. Clearly, at some point, if that is passed on in an inheritance, that extra billion dollars that that multibillion dollar family already has, should be taxed—certainly when those who work every day have the money withheld from their pay check every week. That person who got the billion dollars last year in asset increase, certainly should be paying that tax either this year or when that asset is sold or when he dies and the asset eventually is sold.

Mr. STARK. And you are not concerned that all of those profits that belong to the Graces and the Rockefellers and all those folks, are purely the result of inflation and that really the National Association of Manufacturers would have you believe that they actually have less money now than when old John D. started the oil trust because all they got left is inflation. How do you answer that?

Mr. OSWALD. Mr. Stark, there are many poor people who are homeless. That is because their jobs have been lost because of plant closings and other things. The Rockefellers, the Du Ponts, and the others, are not homeless. They still have their palatial homes. They still have large amounts to spread among even larger and larger numbers of growing family. There is not hardship there. The hardship is on the other side.

Mr. STARK. Well, let me ask you one further thing. It has been suggested that between selling our national assets, which perhaps, some companies should do to pay for their unfunded pension liabilities but they do not think it is such a good idea for the companies to do that, but it is a pretty good idea for the Federal Government to sell off its productive assets to fund the deficit. There is strong pressure for a constitutional amendment to require a balanced budget and let's assume, just for a minute, that we were sitting here and that was the law of the land today. How would you recommend that we go about fulfilling this, sort of, death wish of the present administration. What would we do today? What would be Labor's position on how we would balance the budget today?

Mr. OSWALD. Mr. Stark, to balance the budget today, in terms of the needs of the country, and that is really the first question, what does the country need to do and the Constitution sets forth——

Mr. STARK. That has never bothered the administration. But, go ahead.

Mr. OSWALD. And in this 200th anniversary of the Constitution, we should look and see what it says and the Constitution says two things. One is to provide for the national defense and second, to take care of the welfare of the country. Well, we believe that that is the responsibility and on the other hand, you have to raise the revenue to do that. If you do not raise the revenue to do that, you keep on saddling future generations with a bigger and bigger debt and just pushing it off. So the question is to raise the money to do it. The President, even if he had a balanced budget amendment, if he really believes that the defense budget that he has called for is needed, and if he believes that those other programs that he put forth in his own budget are needed, and I assume he believes that they are needed, then a balanced budget recommendation would require more revenue.

Mr. STARK. It makes sense to me. Thank you very much.

Mr. MATSUI. Thank you. Mr. Rangel will inquire.

Mr. RANGEL. Thank you. Dr. Rahn did the U.S. Chamber support the 1981 Economic Recovery Tax Act?

Mr. RAHN. Yes, with a number of exceptions. We did finally decide, that on balance, the 1981 Economic Recovery Tax Act had more benefits than costs and supported the act.

Mr. RANGEL. And do you still support the concept that was in the 1981 Tax Act?

Mr. RAHN. Yes.

Mr. RANGEL. And were you supporting the President's 1981 strategy to balance the budget?

Mr. RAHN. We were supportive of the expenditure reductions, as well as the tax changes in the 1981 act.

Mr. RANGEL. How about constitutional changes in order to——

Mr. RAHN. We have been in favor of a balanced budget or tax limitation and expenditure amendment. We have also been in favor of the line item veto and in favor of budget process reform.

Mr. RANGEL. And did you come out publicly and support the President in his 1981 legislative initiative?

Mr. RAHN. Yes, we did.

Mr. RANGEL. Since that time, do you think the President has stayed on track with his balancing the budget thrust that he entered the office with?

Mr. RAHN. No.

Mr. RANGEL. Has the U.S. Chamber been as vocal since the initial support of the President since that time?

Mr. RAHN. We have been critical of the President for not being forceful and we have also been critical of the administration for not being bolder on spending reform. We have also been very critical of the U.S. Congress. In fact, just a week ago, I asked my staff to analyze the President's and Congress' budgets from 1981–1986. The results show that the President's budgets from 1981 to 1986 ended up with large deficits, but the Congress, during those years, spent, according to the CBO mark, $92 billion more than the President requested.

Mr. RANGEL. Dr. Rahn, I am fully aware of the sinful conduct of the Congress. What I am trying to find out concerns the President, who signs these bills and who has supported increases in taxes. I just wondered whether the U.S. Chamber of Commerce was as vocal in terms of the President's defense budget expenditures, or the tax reform acts, I just want to see if you have been consistent, as relates to the President's conduct, not to criticism of the Congress, which I know has been consistent because I watch your TV show from time to time. But, I am concerned about what I view as the silence of the chamber, as it relates to the President's doubling of the deficit and I just wondered whether I missed any of the statements that the chamber has made publicly?

Mr. RAHN. We have publicly called many times for vetoing expenditure bills. The Congress has made it increasingly difficult for the President to do so since Congress now places virtually all expenditures into one bill. When you refer to the President's doubling of the deficit, reading the Constitution, the Congress is the one that taxes and spends, not the President. I wish the President had taken a much harder line against the spending of the Congress and we, at the chamber, have consistently urged, both privately and publicly, that the President take a tougher position on the budget than he has.

Mr. RANGEL. But the President has supported every tax increase that the Congress had since he's been in office. Did you support every tax bill?

Mr. RAHN. No. We did not support the 1982 tax increase.

Mr. RANGEL. Well, when you disagree with the President, how does the chamber do this? I mean, do you purchase ads in the newspapers? I think you did that in 1981 in support of the President. What have you done——

Mr. RAHN. The U.S. Chamber rarely purchases ads. In 1982, we were in a knockdown, dragout fight with the President and the administration. Having borne some of the brunt of having the admin-

istration upset with our position, I can still remember that quite vividly. Dick Lesher and I appeared on how many different TV programs and were very forthright in our disagreement with the President. We fought that tax increase tooth and nail.

Mr. RANGEL. When you say the President comes down heavy on you, how does the President express his displeasure with what you have to say or do?

Mr. RAHN. The administration will lobby the chamber like any other organization by calling members of our board of directors encouraging them to support the administration's position.

Mr. RANGEL. But the President does not call you and say he is dissatisfied with your criticism.

Mr. RAHN. No, the President does not.

Mr. RANGEL. We are talking about——

Mr. RAHN. We are talking about the chamber board of directors.

Mr. RANGEL. As it relates to the present budget that was submitted by the President, I mean, for lack of a better word, I will call it a budget, did the United States Chamber of Commerce analyze the budget that was submitted by the President to Congress?

Mr. RAHN. Yes, we did.

Mr. RANGEL. And did you support that budget?

Mr. RAHN. Yes.

Mr. RANGEL. Now, tell me what you did so that we Members of Congress could check the records. What did the chamber do to support the President in what he presented to the Congress?

Mr. RAHN. We submitted testimony before the Budget Committee, in essence, saying the President's budget was a starting point. We also made a number of other suggestions for reductions in expenditures beyond what appeared in the President's budget.

Mr. RANGEL. Now, when it came to the revenue side of the, again, for lack of a better word, but I guess you could call it revenue enhancement, did you support the method in which the President raised some $6 or $7 billion in his so-called budget?

Mr. RAHN. No.

Mr. RANGEL. Did you oppose that? Did you have a better way to raise revenue or did you oppose just raising revenue at all.

Mr. RAHN. Our position has been opposition to tax increases. We have however supported real user fees.

Mr. RANGEL. Well, the President does not support tax increases either.

Mr. RAHN. Again, as we heard the debate this morning, there are often questions as to what is a tax increase and what is not. I think the President has several billion dollars of tax increases in his budget, according to our definition of a tax increase.

Mr. RANGEL. So, a sale of assets, all of the things that the President was trying to enhance the revenues with, you oppose all of them?

Mr. RAHN. No. We are in favor of selected asset sales, user fees and various privatization initiatives.

Mr. RANGEL. Well, right now, do you believe that we need to raise revenues in order to reduce the deficit?

Mr. RAHN. I believe the way to reduce the deficit that would be beneficial to most Americans and increase both job opportunities and real wealth, would be through expenditure reduction. I have

laid out in my testimony, a number of ways to increase revenues that I believe would not be destructive to the economy.

Mr. RANGEL. Well, I cannot tell you, over the year, how helpful the United States Chamber of Commerce has been when the Congress is wrestling with these very sensitive questions and I want to thank you for the great contribution the chamber has made historically toward the solutions of the economic problems facing the Congress and the Nation.

Mr. RAHN. Thank you very much.

Mr. MATSUI. I would like to thank the four gentlemen on this panel for their testimony. We will take their written testimony under submission. Thank you very much. At this time, I would like to call panel No. 3, which consists of Robert S. McIntyre, the director for Citizens for Tax Justice; Robert Greenstein, the executive director for the Center on Budget and Policy Priorities; and Mary Bourdette, the director of government affairs for the Children's Defense Fund.

Mr. MATSUI. Members of the panel, your written testimony will be, without objection, entered into the record. I believe at this time we will call upon Bob McIntyre. Mr. McIntyre?

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. MCINTYRE. Thank you, Mr. Chairman. It is a great pleasure to be here in front of the committee again, in front of the tax reform heroes of 1986, and I mean that sincerely. What this committee led the way to doing last year in terms of income tax reform, was a truly monumental achievement. And now we are back, less than a year later, looking for ways to raise revenues to meet the budget targets and to raise them in ways that I hope do not undermine all the things that Congress achieved last year, in terms of making the tax system fairer.

Of course, raising taxes is not much fun. Cutting spending is not fun. But, we think, this year's effort should be seen not just as a burdensome chore, but as an opportunity to move forward in the direction of the progress towards tax fairness that this committee led the way toward last year. Now, you have, of course, a long book of options that the staff has put together. It is a very useful document. We hope, that in choosing among these options to raise revenues, you will keep three principles in mind.

One is that you should avoid the kinds of regressive tax increases that would undermine what middle and low income families gained from last year's tax bill. Second, we think the highest priority should be given toward preserving and extending the loophole closing measures of last year that brought a measure of fairness back into the system. And finally, it seems to me that there is a serious question when the committee and Congress is talking about tax increases, about whether tax cuts that might benefit the very wealthy segments of society ought to be put into place at the same time. Let me elaborate just briefly on those three points.

First of all, one of the sets of options before the committee, of course, is to raise revenues using excise taxes, taxes on gasoline or cigarettes or beer or telephone or whatever. We hope you will not

take that route because excise taxes, as the members know, are an extremely regressive way to raise revenues. Indeed, if the committee were to raise the entire $19.5 billion with excise taxes, you would find that most American families would lose the benefits they gained from last year's tax reform bill. On page 2 of our testimony, we have a graph indicating how a typical excise tax package might work, in terms of shares of family income. I think you can see there, as you already know, I am sure, that the low income and the middle income families pay the lion's share while the very upper income families pay little or nothing as a share of their income.

And we suggest also, that when you are thinking about excise taxes, you should remember what has been going on at the State level. Around the country, excise taxes have been going up rapidly over the last couple of years. Indeed, last year, 10 States raised their gasoline taxes. This year, another 11 have done so. Cigarette taxes have gone up in 13 States last year, another 4 this year, and there will be more. So that the national excise tax system is already becoming much more burdensome, particularly on low- and middle-income families. We hope that this committee will not make that worse.

Well, the good news is that the committee does not have to sabotage tax reform, because there are other alternatives that are available. We heard the Treasury Department this morning say that they supported the President's revenue package and you might note that one of the items in the President's package is to close one of the egregious income tax loopholes in the Tax Code today, disabled coal miners currently do not have to pay tax on their black lung benefits, and the administration thinks that is an abuse that cries out for correction. Well, I am not sure that is my top priority in terms of income tax reform. But it seems to me that if that is not a tax increase, and we heard today quite clearly that it is not, that closing other loopholes in the income Tax Code, might be an area where the President might be willing to negotiate. Certainly, we would not want to raise taxes, but we might want to correct the waste, fraud, and abuse in the tax system.

And in that light, I would like to highlight a couple of suggestions we have, all of which I guess are in the pamphlet. There are other ideas in the pamphlet as well, but let me just point to a few of them we think are particularly important. One of them is preserving the corporate income tax. Last year, the committee and the Congress revitalized the corporate tax after many years of it going downhill. But the clever tax lawyers and accountants are out there trying to find ways around what was done. And one of the ways is to try to eliminate the corporate tax through the back door, through things like master limited partnerships, through things like over-leveraging of companies, through setting up devices so that what are in effect, dividends will be treated as deductible interest payments. We hope that the committee will explore all of those areas and crack down on them before they get out of hand, because if we are going to preserve what was enacted last year, I think that that has to be done.

Now, there are a number of other areas in the loophole-closing area that we think ought to be examined. One involves deprecia-

tion, particularly for leased assets, where the final tax reform bill did not go nearly as far as the committee wanted to go last year. Then, also, there are companies out there that are finding ways to buy and sell tax breaks. There are still many accounting abuses. In the foreign area, we still have incentives for companies to move plants overseas that we hope the committee will consider getting rid of. And a number of other important areas in the income tax also should be addressed.

Now, finally, as I see my time is ending here, I think the committee has to address a very critical question as part of the revenue bill. One of the reasons that revenue increases are being considered now are the large tax cuts that are scheduled for next January 1, cuts in the estate tax and cuts in the income tax, both of which are targeted for the very richest people in the country. In other words, quite literally, the tax increases that have to be passed this summer are there to pay for tax cuts that result from previous legislation, but have not yet gone into effect.

We think the committee ought to reconsider some of those cuts as a way to raise revenues more fairly than putting the burden on middle- and low-income people.

So finally, let me say that last year, this committee, I think, exceeded the expectations of many people in America—although not mine, because I always had high expectations—and I hope, that you will continue in the progress that you made last year. Because, really, I think the members of this committee have the potential to go down in history as the saviors of the fair tax system in this country. And what happens this year is going to have a lot to do with whether history will remember you that way. Thank you.

[The statement of Robert S. McIntyre follows:]

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CTJ

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Statement of Robert S. McIntyre
Director, Citizens for Tax Justice
Before the House Committee on Ways and Means
Concerning Ways to Increase Revenues
To Meet the 1988 Budget Targets
July 7, 1987

Less than a year ago, Congress enacted the Tax Reform Act of 1986. It was a monumental achievement, restoring a measure of fairness to an income tax system that was sadly in need of repair. The tax reform act went a long way toward assuring that those with the greatest ability to pay taxes would no longer be able to escape their responsibilities entirely, while giving relief to those less able to pay. Now Congress, beginning with this Committee, faces a new challenge: to raise the revenues needed to meet the fiscal 1988 budget targets without undermining the fairness gains instituted last year.

Raising taxes, or, for that matter, cutting spending, is never a happy task. But we believe that this year's revenue bill should be seen not simply as a burdensome chore, but also as an opportunity—an opportunity to continue the progress toward a fairer tax system begun in 1986.

The staffs of the Committee and the Joint Committee on Taxation have compiled a long list of potential revenue-raising measures for the Committee's consideration. In choosing among them, we hope that the Committee will keep the following principles in mind:

1. Congress should avoid regressive tax increases that undermine the benefits middle- and low-income families gained from last year's tax reform act.

2. Further loophole-closing measures that preserve and extend the tax reforms enacted last year should be given the highest priority.

3. At a time when tax *increases* are necessary, further tax *cuts* that would benefit the wealthiest segments of our society should be eschewed.

1. The Trouble With Regressive Excise Taxes

The biggest threat to tax reform is that Congress may attempt to meet its 1988 budget targets through stiff increases in federal excise taxes.

One set of options outlined in the staff pamphlet is to increase excise taxes on gasoline, alcohol, tobacco and telephone services. For example, adding 12 cents a gallon to the gasoline tax, 49 cents to the tax on a six-pack of beer and 52 cents to the tax on a bottle of wine, doubling the 16-cents per pack cigarette tax and extending the scheduled-to-expire three-percent telephone tax would raise just about the amount Congress needs to meet its three-year revenue target. More than half of that money would come from the increase in the gasoline tax, which raises almost $1 billion for every penny added to the tax.

What's wrong with higher excise taxes? What's the big deal about asking people to pay an extra half a buck for beer or wine, and an extra dollar and a half to fill their gas tanks? The answer, in a nutshell, is that these taxes are an extremely regressive way to pay for government.

According to a January 1987 Congressional Budget Office study, the just-described package of excise tax increases would cost families earning less than $10,000 a year more than 2½ percent of their incomes. That's more than double the tax cut the poor gained from last year's tax reform act. Middle-income families would pay about one percent of their earnings in increased excise taxes—again, more than they will save in income taxes from the 1986 reform act. But the richest families, those making more than $200,000 a year, would pay a mere 1/10th of a percent of their incomes in higher excise taxes, meaning that they'd keep most of their 1986-enacted tax cuts.

Effects as Shares of Family Income Of Meeting the Budget Targets With Excise Taxes

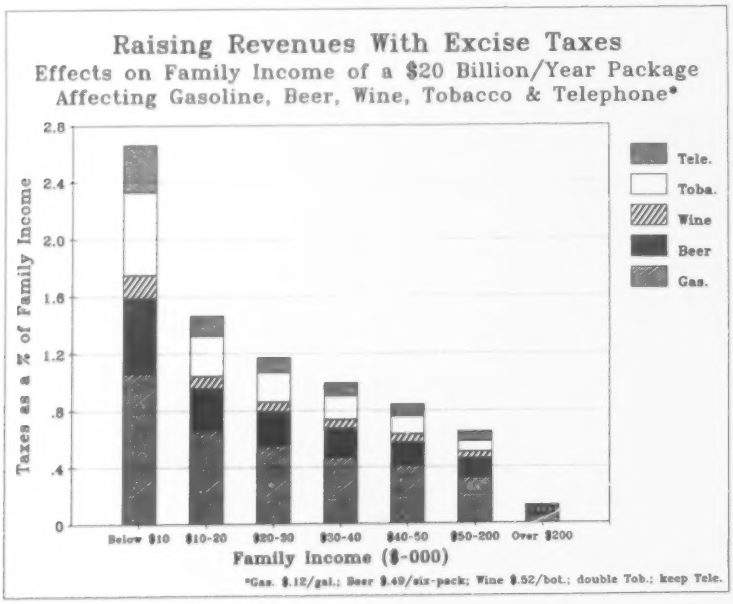
(Raise Gasoline Tax by 12¢/Gallon; Beer Tax by 49¢/Six-Pack; and Wine Tax by 52¢/Bottle. Double Tobacco Tax & Extend Telephone Tax)

Family Inc.	Gasoline	Beer	Wine	Tobacco	Tele.	TOTAL	86 Tax Cut
Below $10,000	1.1%	0.5%	0.2%	0.6%	0.3%	2.7%	-1.1%
$10-20,000	0.7%	0.3%	0.1%	0.3%	0.1%	1.5%	-1.3%
$20-30,000	0.5%	0.2%	0.1%	0.2%	0.1%	1.2%	-0.8%
$30-40,000	0.5%	0.2%	0.1%	0.2%	0.1%	1.0%	-0.8%
$40-50,000	0.4%	0.2%	0.1%	0.1%	0.1%	0.8%	-1.0%
$50-200,000	0.3%	0.1%	*	0.1%	0.1%	0.6%	-0.3%
Over $200,000	*	*	*	*	*	0.1%	-0.5%

*Less than 0.05%

Sources: CBO, Consumer Exp. Survey, Jt. Comm. on Taxation.

Such a package of excise tax increases would take 21 times as big a share of income from the poor as from the richest people. And a similarly skewed distribution of tax increases would occur no matter which combination of excise tax hikes might be concocted.



Excise taxes don't take a larger share of income from poor and middle-income families because these families drive more, smoke more, talk on the phone more or buy more alcohol than the rich. To the contrary, the less a family makes, the less it typically spends on all these items. The problem is that the amounts spent by poorer families are a much larger share of their limited earnings. For example, the $900 that a family earning between $10,000 and $20,000 typically spends on gasoline amounts to about 6 percent of the family's earnings. In contrast, the $1,800 that a very rich family (making more than $200,000) spends for gasoline is less than 0.3 percent of its income.

The prospect of higher federal excise taxes looks even worse when the situation in the states is taken into account. Most states and some local governments also tax gasoline, tobacco, alcohol and telephone service, and these taxes have been going up dramatically in recent years. As a result, higher federal excise taxes would come on top of an increasingly regressive total national excise tax structure. For example, at present, the average federal and state tax on gasoline is 21½ cents per gallon and the average federal and state tax on cigarettes is 33.9 cents per pack. This year, eleven states already have increased their gasoline taxes and four have raised their cigarette taxes. Last year, there were ten state gasoline tax hikes and thirteen state cigarette tax increases.

Moreover, higher gasoline taxes, in particular, would create significant regional disparities. Washington, D.C., with its extensive system of public transportation, has the lowest gasoline consumption per capita in the United States, but the situation is quite different in less densely populated places. Geographically, the big potential losers from a gasoline tax live in the south and the west. According to a 1986 study by the Social Welfare Research Institute, South Carolina, Wyoming, Montana, South Dakota, Arkansas, Mississippi, Alabama, Tennessee, New Mexico and Utah would be the ten hardest hit states when it comes to a gasoline tax hike as a share of personal income.

Increased excise taxes, proposed tariffs on imported oil or suggestions for some kind of new national sales tax, all share a common defect: they would put almost all the burden of deficit reduction on those least able to afford it. And, by doing so, these kinds of tax increases threaten to sabotage the fairness gains of last year's tax reform act. Fortunately, higher excise taxes are not the only alternative before the Committee.

2. Continuing in the Spirit of the 1986 Reform Act.

Last year's reform act did a great deal to restore fairness to the federal income tax code, by cracking down on many tax freeloaders and by making it more likely that people with similar incomes will pay about the same amount in taxes. But the task of tax reform is not over. In fact, only by continuing in the spirit of the 1986 act can Congress preserve the victories that were won last year.

Even the President, in the budget he sent to Congress, was able to find one "loophole" in the revised tax code that he thought cried out to be closed: the tax exemption for black lung benefits received by disabled coal miners. While this item is not high on our list, its inclusion in the President's budget does suggest that loophole-closing is one avenue of deficit reduction that may be negotiable with the administration.

And as the staff pamphlet illustrates, there are, in fact, numerous loopholes left over after tax reform—loopholes that, we believe, ought to be narrowed or closed as ways to meet the budget targets. Without repeating all of the details in the pamphlet, we'd like to highlight several items here:

a. Preserving the corporate tax:

Last week, the administration testified before the Subcommittee on Select Revenue Measures in support of taxing so-called "Master Limited Partnerships" as corporations. We support this recommendation.

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Over the past several years, and increasingly in recent months, large, corporate-like entities have been formed or restructured as publicly-traded partnerships. These entities have been established in a wide and growing range of activities, including elderly care, energy, real estate, portions of Burger King, leasing, gambling casinos, industrial-parts distributors, and even the Boston Celtics. The purpose of using the partnership form is simple: to avoid the payment of the corporate income tax.

Indeed, master limited partnerships (or "MLPs") are nothing but publicly-traded corporations masquerading as a partnerships. Partnership units in MLPs are sold on the stock exchange just like shares of stock. Limited partners in an MLP do not participate directly in the management of the company and are not liable for the debts of the company, just as shareholders don't manage and are not liable for the debts of a corporation whose stock they own.

The big difference between a corporation and a master limited partnership involves taxes:

- As a corporation, a company pays income taxes on its taxable profits each year. When profits are distributed to shareholders as dividends, the dividends are included in the taxable income of shareholders (except those that are tax-exempt, such as pension funds, foundations, or (mainly) other corporations).

- If a company is set up as a master limited partnership, there is no corporate income tax. Owners of partnership units are taxable on their share of the company's earnings each year (whether or not the profits are paid out to the owners).

Like the Treasury Department, we are deeply concerned about the growth in master limited partnerships. In the long run, these devices threaten to undermine the just-revitalized corporate income tax.[1] In addition, MLPs have the potential to sabotage the new individual alternative minimum tax (by generating "passive income" to soak up tax-shelter losses), and they create mind-boggling audit and collection problems for the Internal Revenue Service.

We recommend that master limited partnerships be treated as corporations (with only a short transition period for existing MLPs to restructure their affairs).

In addition, we believe that the Committee should go further in examining partnership issues and in curbing the growth in other avoidance devices that also threaten the integrity of the corporate income tax. For example, the trend in recent years of companies substituting debt instruments for stock raises serious concerns. We recommend that the Committee consider denying interest deductions for over-leveraged corporations, and also consider treating profit-contingent "interest" payments as non-deductible dividends rather than as deductible payments.

b. Depreciation reform:

According to the Joint Committee on Taxation's most recent tax expenditure analysis, by far the biggest tax break left for corporations in the reformed tax

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[1]Those who defend MLPs have argued that they serve to mitigate the so-called "double" taxation of corporate profits. In fact, however, "double" taxation is largely a myth, even after tax reform.

In 1985, approximately 39 percent of corporate profits were subject to corporate income tax. Dividends reported on personal tax returns (representing just over 40 percent of total dividends paid, excluding intercorporate dividends) amounted to 15 percent of corporate profits, and net capital gains on corporate stock reported on personal tax returns totaled 5 percent of corporate profits. Thus, less than 60 percent of corporate profits were subject to tax—notwithstanding the so-called "double tax." [The total effective tax rate (both corporate and personal) on corporate profits totalled about 25% in 1985.] In comparison, essentially all cash wages were reported on personal tax returns.

The under-taxation of corporate profits is lessened under tax reform. In 1988, approximately two-thirds of corporate profits will be subject to corporate income tax. When dividends and capital gains reported on personal tax returns are added in, a total of almost 90 percent of corporate profits will be subject to tax. [In 1988, when rate reductions are factored in, the effective corporate and personal tax rate on corporate profits will total about 28%—an increase of about 13 percent compared to 1985.] But the share of corporate profits that are taxable is still below the share of cash wages that are reported on personal tax returns.

code is the still excessive system of write-offs for depreciation, which is expected to cost a staggering $227 billion over the next five years. Slowing down the rate of acceleration—by using 150-percent declining balance where double-declining balance is now allowed, and substituting 125-percent where 150-percent is now prescribed—would stanch this revenue hemorrhage. Or, at least, the Committee could make some sense out of the depreciation rules for leased equipment. Right now, to qualify as a "true lease" for tax purposes, taxpayers have to aver that the machinery being leased has a useful life of no less than 125 percent of the lease term. (Otherwise, the deal wouldn't be a lease; it would be an instalment sale.) So why not take the lessors and lessees at their word, and make the write-off period for leased property be, at minimum, 125 percent of the lease term?

c. Tax-benefit transfers:

One the tax scandals of the early 1980s was the practice (briefly sanctioned by the 1981 tax act) of companies buying and selling excess tax benefits. This practice continues to some extent, and we believe it should be curbed. In particular, we recommend that the committee examine some of the problems outlined in the staff pamphlet involving tax-benefit mergers, sales of losses using preferred stock and abuses of consolidated returns (notably involving corporate ownership of property and casualty insurance subsidiaries).

d. Accounting issues:

The staff pamphlet points to a number of problems in tax accounting that we believe the Committee should address. In particular, the continued use of "completed-contract accounting," most notably by defense contractors, should be eliminated.

e. Foreign issues:

The staff pamphlet also points to several problems in the foreign area that we believe should be corrected. Notable among these are: the source rules for allocating profits between domestic and foreign sources and the allowance of tax deferral on runaway plants, both of which can provide incentives for companies to divert resources and jobs to overseas operations, and the lack of a withholding tax on foreign investors, which encourages international tax evasion and hurts our trade balance by artificially supporting the value of the dollar.

f. Business meals:

Newspaper reports make clear that the posh restaurant business is not suffering from the tax reform act's restriction on business meal deductions to 80 percent of what's spent. So why not lower to the deduction to 50 percent—and raise $6.6 billion over the next three years? Why should American taxpayers still be subsidizing the eating habits of the well off?

g. Corporate and tax-shelter farming:

There was a lot of talk last year about getting rid of tax-shelter farming, but the restrictions on deductions for so-called farm "losses" could use some more teeth. Right now, all a tax-shelter farmer has to do to avoid the "passive loss" restrictions is make sure he or she plays a minimal "management" role in the farm operation. Abuses in this area could be curbed by treating farm "losses" the same as real-estate "losses"—by definition, not allowed to shelter non-farm income once "losses" exceed a certain amount. At the same time, if Congress really is concerned about bona fide family farms, corporate farm losses ought to be subject to the passive-loss limits and large farms should no longer be allowed to use the "cash accounting" system designed to simplify bookkeeping for small farmers.

h. Capital gains on inherited assets:

Taxing capital gains when people die, instead of letting heirs inherit property and stocks with the taxes on built-up capital gains totally forgiven, could raise more than $10 billion over the next three years, and reduce the current disincentive for people to sell things while they're alive. (Special rules for farms and small businesses could be drafted to deal with particular problems in these areas.)

i. Home-equity loans:

People who are worried (rather than ecstatic) about the boom in home-equity loans probably have a point. The limits on consumer interest deductions were not sufficiently thought through last year. If Congress is serious about those limits, mortgage interest deductions should be limited to loans taken out to purchase or improve a home (with refinancing still allowed up to the amount owed on an acquisition-connected loan). This approach would retain the tax break for home purchases, but avoid the revenue losses and enforcement problems associated with the current rules.

j. Alternative minimum tax:

Strengthening the alternative minimum tax for individuals and corporations—by broadening the base or increasing the rates—should also be considered by the Committee. Insofar as the minimum tax base is brought closer to actual profits or earnings, and insofar as the rates are brought closer to the rates in the "regular" personal and corporate taxes, the minimum tax will do a better job of assuring that those with the greatest ability to pay taxes are actually paying their fair share of the tax burden.

3. Will Congress raise taxes to pay for tax cuts for the wealthy?

The debate over raising taxes to meet the fiscal 1988 budget targets comes at a time when, under previously enacted tax legislation, tax cuts are scheduled to go into effect starting on January 1, 1988 that mainly will benefit the very wealthiest Americans. We believe that the Committee should consider deferring or repealing these scheduled tax cuts, rather than raising taxes on middle- and low-income families.

Next year, unless Congress acts, the top estate tax rate is scheduled to drop from 55 percent to 50 percent. Freezing the top estate tax rate at 55 percent would avoid $500 million in revenue losses over the next three years—and stop the ongoing decline in the estate tax. Only the very largest estates (those worth well over $2 million) would be affected by this freeze.

Finally, Congress should take another look at income tax rates. On January 1 of next year, the rate on the highest income people is scheduled to drop from 38½ percent to 28 percent. If that occurs, half of the richest people in the country will end up with tax cuts averaging more than $50,000 each. Freezing the top income tax rate at its 1987 level of 38½ percent for people making more than $200,000 would be consistent with the House-passed version of the 1986 tax reform act, and could avert as much as $20 billion in 1988 tax cuts for the very wealthy (depending upon the treatment of capital gains). Indeed, merely extending the 33 percent top rate, which is currently scheduled to apply to taxable income between $71,000 and $192,000, to taxable income above $192,000 would raise close to $9 billion per year—all of it from the richest one percent of the population.

Some have argued that the scheduled income tax cuts for the rich are sacrosanct, that they are part of a pact with the American people that must not be broken. But the public does not agree with that position. Indeed, a recent poll found that, by a three-to-one margin, the public supported freezing the top tax rate instead of increasing excise taxes.

Conclusion:

Last year, this Committee led the way for the most sweeping reform of the income tax in memory. This year, the Committee faces the job of increasing taxes. We hope the Committee will treat its task as an opportunity to further the goals of tax reform—and not undermine reform with regressive tax hikes that reverse the progress of last year.

Mr. PICKLE. Thank you, Mr. McIntyre. Now, the Chair would recognize Mr. Greenstein. Are you making a statement separate and apart from the statement of Mary Bourdette? Do you both have statements?

Mr. GREENSTEIN. We have one joint statement, Mr. Chairman.

Mr. PICKLE. Are you going to present it?

Mr. GREENSTEIN. Yes, sir.

Mr. PICKLE. The Chair will be pleased to hear you.

STATEMENT OF ROBERT GREENSTEIN, EXECUTIVE DIRECTOR, ACCOMPANIED BY DAVID KAHAN, PRINCIPAL TAX ANALYST, CENTER ON BUDGET AND POLICY PRIORITIES, AND MARY BOURDETTE, DIRECTOR OF GOVERNMENT AFFAIRS, CHILDREN'S DEFENSE FUND

Mr. GREENSTEIN. Mr. Chairman, this statement is presented on behalf of both the Center on Budget and Policy Priorities and the Children's Defense Fund. With me today is David Kahan, the center's principal tax analyst and Mary Bourdette, director of government affairs for the Children's Defense Fund. Mr. Chairman, these two organizations, as I think most members of this committee know, were strong supporters of last year's Tax Reform Act. In fact, these two organizations were the lead organizations in rallying support from other groups concerned with low income and poverty issues for this legislation. In addition, these two organizations are also strong supporters of this year's congressional budget resolution, and in anticipation of a question Mr. Rangel asked of some of the previous witnesses, we do believe that revenues are necessary in order to help reduce the deficit that now besets our economy.

It seems to us that the key issue this year is that we would hope that the committee would continue with this year's tax legislation in the same vein as was reflected in last year's tax reform act. In particular, we would encourage the committee to raise revenues in a fashion that does not place an undue burden on those with low and moderate incomes. We think this is of special importance as the committee considers raising excise taxes and we would urge that excise taxes be no more than a modest portion of the total package. Moreover, if excise taxes are included, we would urge that the committee offset the regressive nature of these taxes, by taking additional actions, such as adjusting the earned income tax credit for family size.

The basic principle, we think, is the one of ability to pay and in that vein, in this age of high deficits, tax expenditures should be subject to the same tough scrutiny as direct spending. Tax credits, exclusions or incentives that distort economic behavior, benefit one form of investment over another, with no overriding social purpose, or whose economic returns are small, are an inappropriate allocation of scarce public resources. We would urge consideration of some of the base-broadening reforms that were included in last year's tax reform bill approved by the House in the fall of 1985, but which did not make it into the final legislation. In addition, there are many meritorious reforms suggested in the Joint Committee pamphlet and we would also support the provisions on Mr. McIn-

tyre's list to close further loopholes and also to reconsider the issue of the top rates.

By contrast, we think it would not be equitable to reduce the deficit on the backs of those with low and moderate incomes. Earlier in this decade, large scale reductions in spending fell disproportionately on these people. Programs that serve low income people are ten percent of the budget. CBO data shows that constituted nearly a third of the cuts in 1981 and 1982, and these Americans have already sacrificed more than other citizens to bring the deficit down. In addition, there has been a significant erosion in tax fairness in recent years, both due to the increasing reliance on regressive taxes, such as payroll taxes. The fact that the reductions earlier in the 1980s resulted in increased taxes at the state level that were regressive, and studies showing that the state systems themselves had been becoming increasingly regressive in recent years, leading to an overall flattening out of the Nation's tax system.

It may be of interest to the committee that just about ten days ago, the Census Bureau released new data on after-tax incomes in the United States, showing that the poorest fifth of all households received only 4.6 percent of the Nation's after-tax income in 1985, the smallest percentage recorded in the 1980s. By contrast, the share for the top fifth has consistently increased and the top fifth in this country now receives $34 billion more a year in after-tax income than if the shares of national after-tax income had simply remained the same as in 1980. Finally, that census report shows that for families below $10,000, total tax burdens have gone up 19 percent, as a percentage of income, since 1980. No other income group has had a similar impact.

So, to repeat, we would urge the committee not to rely too heavily on excise taxes as a means of raising revenues this year. Having said that, we would note that all excise taxes are not created equal. In the appropriate context where all taxpayers are being asked to share payment fairly and the revenues are being dedicated to important areas, certain excise taxes would be acceptable, notwithstanding their regressive effects, particularly those levied on items that are both discretionary expenditures and that have beneficial deterrent effects, such as excise taxes on alcohol and tobacco. Increasing taxes on these items helps compensate society for the costs imposed by alcohol and tobacco use; could cause consumption to decline, particularly among children and young adults; and could help reduce alcohol-related traffic accidents, lung cancer, and so forth.

By contrast, we see much less positive effect in other excise taxes such as on telephones, which are clearly not discretionary anymore; or royal import fees that benefit corporations more than they raise for the Treasury. We would also recommend that the committee retain the Federal unemployment tax at its current level, rather than allowing a tax cut to take effect next year, which under current law would occur. We think it is good policy to build some cushioning in the unemployment trust fund for a possible new recession at some point in the next several years.

So that we hope that the committee will have excises be only a modest portion of the package and choose carefully among them, but our second key message is that since we recognize excises are

likely to be in the package in some fashion, we hope not too big, we would appeal that the committee take some action to offset their regressive nature. This could be done in several ways. Altering the earned income tax credit so that it varies by family size and making the dependent tax care credit refundable, are actions that would target benefits to the working corps and balance the effect of increasing excise taxes. These can also be designed in various ways to have a range of costs.

Adjusting the EITC by family size is good social policy, as well as good tax policy. It would make working more competitive with welfare for large families, as welfare payments are usually adjusted by family size but wages are not. It would also leave working families with several children with net incomes closer to the poverty line. As currently structured, the EITC provides much less assistance to large families relative to the poverty line than to small families because it does not vary by family size, although the amount of income necessary to keep a family out of poverty rises as family size increases. Indeed, adjusting the EITC so that it increases for larger families, is both pro-work and pro-family and, as a result, has attracted support from an impressive array of liberals and conservatives alike. On record as endorsing this concept are Gary Bauer, the President's Domestic Adviser; last year's White House task force report on the family called for it; Dan Crippen, Chief of Staff, Baker's principal budget aide; the Heritage Foundation; Eugene Steuerle, Deputy Assistant Secretary of Treasury for Tax Policy have all endorsed this as positive policy. We would urge the committee to strongly consider it.

An other option whose merit should be considered is to increase the phase-in rate of the EITC from 14 to 15 percent. While that option is smaller and less important than adjusting the credit by family size, it is needed to compensate for the scheduled increase in the FICA tax rate in 1988. The phase-in rate of the EITC has historically been set at double the rate of FICA tax and the current FICA rate of 7.15 percent dictated the choice of 14 percent as the phase-in rate in last year's tax reform bill. Now that the FICA tax rate is going to 7.51 percent in 1988, the EITC rate should be boosted to 15 percent.

Finally, we would urge consideration of making the dependent care tax credit refundable, which would allow working and near-poor families, who owe little or no income tax but who nonetheless have child care expenses, to benefit from the credit. As a result of last year's tax reform act, these families that have child care expenses are the only child care users who cannot benefit from this tax credit because they have no tax liabilities and the credit is not refundable. This would be a helpful way of increasing the affordability of child care, fostering work incentives and, again, promoting work over public assistance. Therefore, we would hope that these would be included and looked at as you look at the total package. Thank you.

[The prepared statement follows:]

TESTIMONY OF THE CENTER ON BUDGET AND POLICY PRIORITIES

AND THE CHILDREN'S DEFENSE FUND

before the

HOUSE COMMITTEE ON WAYS AND MEANS

July 7, 1987

Mr. Chairman and Members of the Committee, we appreciate the invitation to testify here today. I am Robert Greenstein, director of the Center on Budget and Policy Priorities. The Center is a non-profit research and analysis organization that focuses on public policy issues affecting low and moderate income Americans. With me today is David Kahan, the Center's principal tax analyst. This testimony is also offered on behalf of the Children's Defense Fund, a non-profit organization which focuses on the needs of low income children and their families. Mary Bourdette, the Children's Defense Fund Director of Government Affairs, is also here.

Just over two years ago, in June of 1985, we had the opportunity to testify before the Subcommittee on Select Revenue Measures on proposals for comprehensive tax reform. At that time, we discussed the great need for tax reform for the working poor of this country. This need led us to support strongly the historic tax reform measure that this Committee drafted, and we regard that Act as perhaps the most significant legislative gain low income people have made over the past decade. The Members and staff of this Committee who labored long and hard to produce this achievement have much of which to be proud.

Today's issue, how to increase revenues in order to meet the reconciliation instructions of H. Con. Res. 93, confronts the Committee with many of the same hard choices it faced last year. We hope that the Committee's choices this year will be consistent with last year's bill. In particular, we encourage the Committee to raise these revenues in a fashion which does not place an undue burden on those with low and moderate incomes. This is of special importance as the Committee considers raising excise taxes, which fall more heavily on such individuals than they do on the population as a whole. We urge that excise taxes constitute no more than a modest portion of the revenue package. If excise taxes are included, we urge that the Committee offset the regressive nature of these taxes by taking additional action, such as adjusting the Earned Income Tax Credit (EITC) by family size. I will discuss in greater detail the concept of an offset, and various ways in which it might be accomplished later in this testimony.

I should note that we supported passage of the budget resolution and the resolution's mandate for additional revenues. We are concerned that Congress take action to reduce the current high level of the federal budget deficit, which we regard as a threat to the economy. In addition, the pressing social needs of the country will be difficult to address until this impediment is dealt with.

Our support for increasing revenues is consistent with our support of tax reform. Like many Members of this Committee, we had some concerns about enacting a major tax reform that did not reduce the deficit. Like the majority of this Committee, however, we believed that such a revenue-neutral reform was still well worth enacting. And, like many Members of this Committee, we believed that enacting tax reform would put the country on a far sounder footing to then raise the revenues which might be needed to bring the deficit under control.

We continue in this belief today. Last year's Act clearly showed that Congress and the American people believe that federal revenues should be based on an ability to pay. Those with low and moderate incomes should not be faced with tax burdens they can ill afford. Further, in this age of high deficits, tax expenditures must be subject to the same tough scrutiny as direct spending. Tax credits, exclusions or incentives which distort economic behavior, benefit one form of investment over another with no overriding social purpose, or whose economic returns are small, if any, are an inappropriate allocation of scarce public resources.

As a first step, we encourage consideration of some of the base-broadening reforms which were included in the tax reform bill approved by this Committee in the fall of 1985 but which for one reason or another were not part of the final bill. We would also suggest that there remains much fertile ground for further reforms. The pamphlet prepared by the Joint Committee on Taxation contains no shortage of base-broadening reforms which would be perfectly consistent with last year's Tax Reform Act. Taxing the appreciated value of capital gains at death, for example, is an idea that deserves serious consideration.

Secondly, we well appreciate that the political difficulty of making changes in the rate structure of the income tax renders such a change unlikely. However, purely from a position of fairness and equity, we believe that changes in the top rate are appropriate and should ultimately be considered. At a time of high deficits and large unmet needs, it is hard to justify reducing to 28 percent the top tax rate for the very wealthiest members of our society.

By contrast, it would not be fair to reduce the deficit on the backs of those with low and moderate incomes. This path has already been too well traveled. In the earlier part of this decade, large scale reductions in spending that fell disproportionately on those with low and moderate incomes were made in the name of deficit reduction. Though programs which serve low income people comprise only 10 percent of the federal budget, these programs suffered nearly one-third of all the cutbacks in spending enacted in 1981 and 1982. Low income Americans have already sacrificed more than other citizens to bring the deficit down. The serious human consequences of the cutbacks in low income programs have been well documented.

Less well appreciated is the significant erosion in tax fairness that has also victimized low and moderate income Americans in recent years. At the federal level, there has been an increasing reliance on regressive payroll taxes. In addition, the Urban Institute has found that the cuts in federal taxes and services in the early part of this decade were a factor in leading states to increase their own taxes to deal with the added burdens they faced. The Urban Institute found that this trend further adversely affected those with low and moderate incomes since state tax systems tend to be regressive. Further, several studies, including one by the National Bureau of Economic Research (NBER), conclude that state tax systems themselves have grown more regressive over recent years. The overall effect has been a flattening out of the nation's tax system, a result documented by Joseph Pechman of the Brookings Institution. Though last year's reform was certainly a large step in the right direction, it will not by itself reverse these larger trends.

Within the past two weeks the U.S. Census Bureau has released data which cast new light on this situation. These data show that the gap in after-tax income between the richest 20 percent of American households and the rest of the nation hit its widest point in 1985 (the most recent year for which these data exist). The poorest fifth of all households received only 4.6 percent of the nation's after-tax income, the smallest percentage Census has recorded since this data series began in 1980. At the same time, the after-tax income of the richest fifth increased significantly – so that the top fifth received $34 billion more a year in after-tax income than it would have if it simply maintained the same share of national after-tax income that it had in 1980.

Moreover, between 1980 and 1985 tax burdens on households with incomes below $10,000 a year increased by nearly 19 percent, when measured as a percent of income. Despite the fact that federal income tax burdens were rising for these households over this period, the Census Bureau reports that the bulk of this increase was due to state and local taxes. As a result, the 1986 Tax Reform Act, though immensely helpful to low income families, will not cause a reversal in this basic trend.

Accordingly, excessive reliance on excise taxes as a means of reducing the deficit would exacerbate an already unsatisfactory situation. Our primary objection to excise taxes is that they are imposed without regard to ability to pay. As the recent Congressional Budget Office (CBO) examination of this topic confirmed, low and moderate income individuals would pay a substantially higher percentage of their incomes in increased excise taxes than would other taxpayers. Imposing such regressive taxation would be directly counter to the Committee's valiant efforts over the last two years to improve the fairness and progressivity of the tax system. In fact, increased federal excise taxes could cost low and

moderate income families a significant portion of the tax relief that they won last year. We strongly urge the Committee not to rely too heavily on excise taxes as the means of raising new revenues this year.

Having said that let us note that not all excise taxes are created equal. Our positions have long been that in the appropriate context, where all taxpayers were being asked to share the pain fairly, or where the revenues were being dedicated to areas of spending which we view as high priorities, there are certain excise tax increases which would be acceptable, notwithstanding their regressive effects. These are excise taxes which are levied on discretionary items and which have beneficial deterrent effects -- in particular, excise taxes on alcohol and tobacco.

Tobacco and alcohol use both impose costs on society. Increasing the taxes on these items would help compensate for those costs. In addition, increasing the taxes would cause consumption to decline, particularly among children and young adults. Stopping smokers before they start, and decreasing drinking among those most likely to be involved in alcohol-related traffic accidents are exceptionally worthy social goals.

By contrast, there is little positive to be found in certain other excise taxes. What social goal is served be imposing a federal tax on telephone service, on top of a federally ordered line charge? Telephone service should no longer be thought of as a discretionary item, and such taxes and charges are regressive. An oil import fee, which would not only be highly regressive but which would cost consumers $3 for every dollar collected by the Treasury and transfer the remaining $2 to large corporations, is likewise highly objectionable. Even a broadly based energy tax, though much preferable to an oil-import fee, imposes a significant (and regressive) burden on low-income people for consumption which is largely non-discretionary. As the Joint Committee's pamphlet shows, fairer alternative sources of revenues are not hard to come by. Lessening the deductibility of business meals and entertainment expenses, rectifying the tax status of master limited partnerships, or imposing fees on selected luxury items would all be preferable to regressive excise taxes.

We would also recommend that the Committee retain the Federal Unemployment Tax Act (FUTA) at its current level. With the need for revenues so great, there is no overriding reason to go ahead with what amounts to a tax cut for employers. This is especially true given the need of this trust fund to build a level of cushioning. Prudent fiscal policy suggests taking advantage of the current economic recovery to lay the groundwork for dealing with the next recession.

Thus, we hope the Committee will choose to have excise taxes comprise as little of the revenue package as possible, and will carefully choose among various excise taxes with an eye towards their consequences. However, we recognize that it is likely that excise taxes will comprise at least some part of the revenue package. If so, we appeal to the Committee to consider taking some action to offset the regressive nature of such taxes.

Offsetting the regressive effects of excise taxes could be accomplished in any of a number of ways, involving action on either spending or taxes, or some combination of both: the particular option chosen would depend to some extent on the size of the offset necessary. However, an offset can be designed for almost any given amount. We could suggest ways to design an offset whose final cost was $2 billion a year, and we could suggest ways to design an offset whose final cost was $100 million a year. The initial parameter -- how large an offset is necessary -- would need to be determined by the Committee based primarily on how much reliance is placed on regressive taxes.

Perhaps the most promising way of offsetting the regressive effects of excise taxes would be to take compensating action elsewhere in the tax arena. Altering the Earned Income Tax Credit (EITC) so that the size of the credit varied by family size and making the Dependent Care Tax Credit refundable are actions that would target benefits to the working poor and thus balance the effect of increasing excise taxes. Such an offset would help keep this year's measure consistent with the principles which guided last year's reform.

Adjusting the Earned Income Tax Credit (EITC) by family size would not only be good tax policy, but good social policy as well. It would make working

more competitive with welfare for large families, as welfare payments are usually adjusted by family size, while wages are not. This aspect of instituting a family size adjustor to the EITC makes it quite attractive to those concerned with pro-family policies. Further, such an adjustment would leave working poor families with several children with net incomes closer to the poverty line. A full-time, year-round minimum wage job now brings a family of two to the poverty line, but leaves a family of three $2,100 below the poverty line and a family of four $4,400 below the poverty line.

As currently structured, both the EITC and the standard deduction provide much less assistance to large families relative to the poverty line than they provide to small families. This is because neither the credit nor the standard deduction vary by family size, although the amount of income necessary to keep a family out of poverty rises as family size increases. As a result, larger families with poverty level earnings pay a much higher percentage of income in federal taxes than do smaller families.

Finally, this action would follow the common-sense notion that the extent of a low income family's need is a function of it size, not just its income. I think we would all agree that a family of four with $10,000 of earnings is needier than a family of two with the same income level.

Indeed, these benefits of increasing the EITC for larger families -- and the attractive politics surrounding the fact that such a move is both pro-work and pro-family -- have made it a reform called for by liberals and conservatives alike. On record as endorsing adjustment of the EITC by family size are conservatives such as the President's Domestic Policy Advisor Gary Bauer (who called for adjusting the EITC by family size in the White House report on families issued last November), Dan Crippen (Chief of Staff Baker's principal budget aide), and the Heritage Foundation. Eugene Steuerle, Deputy Assistant Secretary of Treasury for Tax Policy and formerly of the American Enterprise Institute, also called for this action in an article written last year.

Another tax option whose merits are sufficient that it should be considered in any case, and which might also serve as an offset, would be to increase the phase-in rate of the EITC from 14 percent to 15 percent. This option is smaller, and much less important, than adjusting the credit by family size, but such an increase is necessary to compensate for the effects of the scheduled rise in the FICA tax rate. The phase-in rate of the EITC has generally been set at double the rate of the FICA tax (since most economists believe that low wage employees actually bear the brunt of both sides of the payroll tax, employer and employee). The current FICA rate of 7.15 percent dictated the choice of 14 percent as the phase-in rate in last year's bill. However, on January 1, 1988, the FICA tax rate will increase to 7.51 percent, for a combined rate slightly above 15 percent. To offset the FICA tax most effectively, the EITC phase in rate should be boosted to 15 percent.

A third option is to make refundable the Dependent Care Tax Credit. This would allow working poor and near-poor families who are owe little or no federal income tax, but who nonetheless have child care expenses, to benefit from this credit. As a result of the Tax Reform Act of 1986, families with incomes below roughly 110 percent of the poverty threshold who have child-care expenses are the only child-care users who cannot benefit from this tax credit because they will have no tax liabilities and the credit is not refundable. Making this credit refundable would be a non-intrusive way of increasing the affordability of child care for poor families. As insufficient child care is a major impediment to work, such a move would foster work incentives and assist those poor families already working.

These items are not mutually exclusive. Indeed, they can be combined in various ways and have several important features in common. First, they target their benefits exclusively to low income working families. This makes them quite cost effective. Secondly, on the issue of cost, these items contain a hidden bonus -- they would have a very small first year cost.

Almost all EITC costs, and all the cost of making the dependent care credit refundable, involve either refunds or reducing tax liability when tax returns are filed. As a result, most of the cost associated with increasing the EITC for calendar year 1988, or for making the Dependent Care credit refundable, will not be incurred *until 1989* and would entail relatively little revenue loss in FY 1988.

Accommodating these costs in the out-years may not prove that difficult for the Committee. To reach $19.3 billion in revenue increases in FY 1988, the Committee may have to enact measures that exceed the revenue targets for the out-years. Thus, the Committee could include these offset options, and still not need to raise much more than the $19.3 billion figure for FY 1988 in order to reach the reconciliation targets.

Notwithstanding the desirability of offsetting the regressive effects of whatever excise taxes may be included in this revenue measure, we would not want to convey the impression that including an offset makes everything alright. Though including an offset makes things much less inequitable than they would otherwise be, significant numbers of the poor -- non-working elderly for example -- would be negatively affected by excise taxes but would receive no compensating offset. Such individuals would disproportionately bear the brunt of deficit reduction, despite the fact that they can least afford to do so. The ideal is still to construct a revenue package that is progressive from the onset. It would be unfortunate if one of the greatest gains of last year's reform -- the tax relief it offered to the poor -- was undone in whole or in part by this year's tax legislation.

Mr. PICKLE. Thank you, Mr. Greenstein. I take it that this panel supported the tax reform bill last year?

Ms. BOURDETTE. Very much so.

Mr. PICKLE. And you think it was an epic and appropriate step to take? I noticed, though, that both of you have indicated that the tax rate went too low and, of course, that was the centerpiece. Instead of a top rate of 28 percent, you think it ought to stay at 38.5 percent. Do you consider that inconsistent with your strong support of the tax bill, the very heart of which last year was to drop rates to an all-time low level?

Mr. MCINTYRE. Well, one of the constraints last year, Mr. Pickle, was that the bill be revenue neutral, and in that context, where there was no effort made in deficit reduction, because the President did not want to do it, I think the rates were appropriate. But now that the deficit has to be cut, I think we have to look around and find out who can bear the burden most easily and most fairly and one way that I think you ought to address is that there is a big tax cut scheduled for next January, when that rate comes down. And that is, I think, why we are proposing that perhaps the rate ought to be kept there or at some midpoint between the 28 and 38, as a way to reduce the deficit. The context has changed, in other words.

Mr. PICKLE. If you were to change the tax rate to 38.5, percent do you consider that a tax increase or just a freeze?

Mr. MCINTYRE. It is an increase over current law. It is a freeze of the existing situation. If I were a politician, I would call it a freeze.

Mr. PICKLE. Well, some politicians may not have the nerve to do that.

Mr. GREENSTEIN. Mr. Chairman, I would also say that we strongly supported last year's tax bill. I think the one element that we had reservations about, but still we had very strong support for the overall package, was the extent of the reduction in the top rate all the way down to 28 percent. We recognize that there are political difficulties in raising those rates this year. Also, we are interested in a tax bill that would be signed and become law and help reduce the deficit. In our testimony, we noted that we think changes in the top rate should ultimately be considered. We recognize that might not be possible this year. I would say, though, that with the deficit still at $180 billion, this year's tax bill is hardly going to be the last tax bill we need. We are going to need more expenditure reductions and more revenue increases in future years to continue to get the deficit down and I think at some point, consideration of that top rate is going to be inevitable.

Mr. PICKLE. Mr. Greenstein, you had indicated in your testimony that you were against the excise taxes, that they are regressive. But I noticed that you also said that if excise taxes are passed, you would hope that they would not be more than just a modest portion of the overall revenue goals. You are saying then, in effect, that you recognize there may well be some excise taxes and you accept a certain amount just so long as it is a just portion? Is that correct?

Mr. GREENSTEIN. I think we are saying several things. We recognize the political difficulties of putting together a package that hits $19 billion, getting it enacted and signed, and that more likely, that it may be necessary to have some excises as part of that pack-

age. We would hope they represent a modest portion, not a majority, No. 1. No. 2, we think there are differences among different excise taxes. We have less difficulty with excises on things such as alcohol and tobacco, both because they are discretionary. Not everybody who is low or moderate income has to smoke or has to drink and also because they have positive health and social affects. We have much more difficulty with excises on such items as telephones or energy, which are really not discretionary, in fact, the overwhelming bulk of low income people incur them. And, finally, we are saying that we think there need to be some other provisions to offset whatever excises are included, particularly in the area of the earned income tax credit.

Mr. PICKLE. Fine. Thank you very much. Mr. Brown?

Mr. BROWN. Thank you, Mr. Chairman. The first question I noticed his concern about the excise taxes. Let me ask, does that concern apply as well to excise taxes on luxury items?

Mr. MCINTYRE. Not particularly, but there is not much money in those apparently, according to the staff pamphlet.

Mr. BROWN. I wonder if that is the case with automobile's for the portion above $20,000 or $15,000, expensive jewelry, furs, travel to exotic places, entertainment. I mean, those are an enormous portion of our economy. Isn't that a significant potential?

Mr. MCINTYRE. Well, apparently, according to the pamphlet, at the rates they suggested, at least, the staff could not find a great deal of revenue in them. I do not know, maybe I do not enjoy enough luxury items. My luxury tax is the $75 that you hit every once in a while going around the board, near Park Place, I think. I think we have to believe the staff on that one, Mr. Brown.

Mr. BROWN. Your testimony has a very fascinating footnote I would like to get to on page 5. But in relation to your remarks on MLPs, I find that an interesting subject suggesting taxing MLPs—let me put to you the concern I have. In talking about MLPs, it looks to me like what we are talking about is taxing something, based on the fact that it is publicly marketed, not taxing it on the reason that, as you suggested, there is no liability for the debts of the company or no participation in the management of the company. I am wondering if you think it is worthwhile looking at all the entities, the pass through entities we have, that allow this same sort of tax situation to occur, rather than just MLPs?

Mr. MCINTYRE. The answer is yes. In fact, in our written testimony, we suggest perhaps too cryptically, that there are many other partnership issues, in particular, that you ought to examine. I think any of these publicly traded, partnerships, even if they are not traded on an exchange probably ought to be treated as corporations. They are more like corporations, I think, than anything else.

Mr. BROWN. Your footnote has some interesting comments in it. It says approximately 39 percent of corporate profits were subject to corporate income tax in 1985.

Mr. MCINTYRE. Before tax reform.

Mr. BROWN. Before tax reform. Now you are referring there to the portion that is exempt under capital gains and offset by the investment tax credit, all of that. What else?

Mr. MCINTYRE. Accelerated depreciation, investment credits, capital gains exclusions, tax exempt dividend recipients. When you

add it up, you get that about 39 percent showed up on somebody's tax return somewhere.

Mr. BROWN. Of course, accelerated depreciation would show up. It is a question of when it is taxed, isn't it?

Mr. MCINTYRE. Well, in any given year, in 1985 in particular, if you take the total of corporate profits and then you compare that to what was showing up on either a personal or a corporation tax return, it was about 39 percent that showed up somewhere. Now, that has changed under reform.

Mr. BROWN. Yes. In that calculation, are you adding back in the amount of depreciation that is simply taken in a different period? I mean, I can see how you would not suspect——

Mr. MCINTYRE. No. You cannot subtract it on one side and not add it in on the other.

Mr. BROWN. Exactly.

Mr. MCINTYRE. I mean, we looked at what is currently taxable.

Mr. BROWN. The suggestion you had is an interesting one. At the bottom, it says effective corporate and personal tax rate on corporate profits will total about 28 percent, an increase of about 13 percent compared with 1985. In other words, the effect of the tax bill we had was to increase the portion of corporate income that is taxable? Is that the right way to say it?

Mr. MCINTYRE. It increased the portion by more than that but because of the rate cuts, the overall burden on corporate income, including taxes on dividends and capital gains, went up by about 13 percent in total. So it had been about 25 percent, and went up to 28 percent, and that change is about a 13 percent change.

Mr. BROWN. Do you feel we are a competitive country, tax-wise, to produce in the world market?

Mr. MCINTYRE. In many ways, we are a tax haven now. We are a tax haven for international investors. We are a tax haven for many kinds of corporate activities because of our low rates. You are already seeing some movement I think, mainly because of the trade problems, but the tax changes may even give a further incentive for foreign manufacturers to set up operations here.

Mr. BROWN. One of the previous witnesses had indicated that our personal rates were attractive, but that our cost recovery, I assume he is referring to depreciation schedules, were not attractive. Would you concur or do you disagree with that?

Mr. MCINTYRE. It depends on which country you compare us to. Canada is very generous now, but they are in the middle of a tax reform effort. They may change that. Japan is not particularly generous, less than we are. West Germany is a mixed bag. Their basic system is not particularly generous but they have so many exceptions and special rules, that it is hard to tell what their system is. So it really varies country-by-country.

Mr. BROWN. Do you have any suggestions on how we can make ourselves a more competitive place to produce products through the Tax Code?

Mr. MCINTYRE. Through the Tax Code? Well, passing this revenue bill might help. I think the big issue is the value of the dollar. I think the last few years have shown that pretty clearly. And insofar as this bill helps cut the deficit and helps keep interest rates

down, I think that will help keep the dollar down and make us more competitive, yes.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. PICKLE. Mr. Matsui?

Mr. MATSUI. Thank you, Mr. Chairman. I just have a very few questions and comments. One, I appreciate the testimony all four of you have given. You are at least coming up with viable options that will be considered. I hope that over the next 2½ days, others will follow your lead and give us alternatives, rather than just come up with what they oppose. I appreciate your efforts. They will be very helpful to us and will go a long ways in leading us in the right direction. Second, if there is any excise tax, I would undoubtedly want some changes in the earned income tax credit so that we do not adversely impact the working poor and those that we helped in the tax reform bill last year.

Third, the one question I have is what is doable. I am assuming that the President will be adamant about vetoing any bill that has any rate change in it and I would imagine a surtax would probably be in that same category, as far as the President is concerned. Assuming that we even put the automatic sequestration of Gramm-Rudman in place, and he begins to negotiate, or at least his people begin to negotiate with us, I would still imagine that he would be opposed to any kind of rate change or a rate freeze. Given that, if we come up with a bill similar to the 1984 bill or the 1982 bill where we try to close more loopholes, maybe there will be some small excise tax in it, but it will be a bill in which we try to pick up some of those things we missed in the Tax Reform Act of 1986. Would that be something that you could support, assuming that there is some excise tax in there? I do not know how much. I could not even tell you the percentage now. The reason I say this is because I do not think we are going to get any help from the other side of the aisle and I think that if the three of you should oppose whatever we come up with, we are going to have problems in getting the tax bill, at least, out of the House. What are your views if we had a luxury tax, estate tax, and some of the things you mentioned in here, but also an excise tax increase with an earned income tax credit.

Mr. MCINTYRE. Well, Mr. Matsui, I suppose it really does depend on the bottom line. If it was $18 billion in excises and $1.5 billion in income tax reforms, we are against it. If it is $1.5 billion in excises and $18 billion in income taxes, we are for it. In between, well it just depends on how it affects the people we represent. That is really what the issue is. I think that you can design a fair package and if you nick a few excise taxes, that is not going to make us jump ship, necessarily. But we think that if you adopt the kind of earned income tax credit approach here, you may use up most of your excise tax money giving relief to people, because they are the ones that pay it, down at the lower end.

Ms. BOURDETTE. Mr. Matsui, I want to express our support for your efforts to raise revenue and we do think it is absolutely essential that there be additional Federal revenue in order to reduce the deficit and we will do everything possible to lend our support and the support of other organizations we work with, to your efforts. Obviously it is impossible to say at this stage, but the kind of bill

that you suggested, that has, for instance, luxury taxes, perhaps plugging additional loopholes that you tried to do last year, continue in the spirit of tax reform, and offset to the degree you can, any negative impact on low income working families through perhaps, increased earned income tax credit or refundable dependent care tax credit, would, we think, be a bill that we could support and would work very hard to pass. It is essential for children that the deficit be reduced. They have paid in the past. They will continue to pay until the deficit is brought down and we would like to work with you as much as possible.

Mr. GREENSTEIN. I would also echo what Mary Bourdette just said and I would like to say that this is a rare occasion where I would have a disagreement, just a modest one here, with Bob McIntyre. But I would say first, that adjustments in the EITC, I think, would clearly not eat up most of the majority of the excise tax, but rather a modest portion and second, a very important point to keep in mind is that because both the EITC, in large part, and the dependent care tax credit, under this proposal to make it refundable in total part, would have their costs occur at refund time, at tax filing time. There would be very little fiscal year 1988 costs. The real cost would not show up until the out years. Now, some of us think that for you to put together a package that hits that $19.3 billion in the first year, you may very well exceed your out-year numbers anyway. And it may give you the room you readily need to package in an EITC and a dependent care adjustment and have the package fit together nicely, as long as those excises stay at a modest level. So I think that kind of a package is doable and if that is what comes forward, we would very strongly support it.

Mr. MATSUI. Thank you. I would like to thank all three of you again for your testimony and the help you have offered us.

Mr. PICKLE. Mr. Dorgan?

Mr. DORGAN. Thank you, Mr. Chairman. Mr. McIntyre, let me ask you to amplify on an answer you gave a few minutes ago. Could you describe, as best you can, our competitive position in the world, vis-a-vis, our tax systems and the Japanese system, the Canadian system, and so on. The reason I ask the question is frequently we will hear testimony before the committee that says it is very important that we not do something to our tax system that would render this country less able to compete. And I agree with that statement. The question is, what about the competitiveness and what is our system versus another country's system.

Mr. MCINTYRE. Well, compared to Japan, we have lower corporate rates, much lower. Their's are now, I guess, in the low 40s, generally, and we are headed toward 34. Japan's tax expenditure budget, the last time I looked, totalled about $2 billion for corporations—in yen of course but I am translating—compared to ours, at the time, which was $100 billion. Ours is still $65 billion, according to the Joint Tax Committee, so we have a lot more tax incentives now. You can argue which approach makes a country more competitive. My view always has been that distortions in the tax system hurt us competitively and that Japan's lack of so-called incentives has been a gain for it. Some of the people who support the incentives feel the opposite way. But compared to Japan, which collects a higher share of its revenue from corporations and has

higher rates and less loopholes, we certainly have lower corporate taxes.

On the personal side, Japan exempts some capital gains from taxes, but taxes venture capital ones very heavily. We now treat them like ordinary income, so we are somewhere in between on that one. We are lighter on venture capital and tougher on stock market gains. Compared to Canada, well, Canada's tax system is in the process of reform and I cannot tell you how it is going to come out. In the past, they have had very rapid capital cost recovery or depreciation and tax credits. West Germany is kind of a mish-mash. They have, on the books, a very tough looking system. In practice, it does not look so tough because they have so many special rules. If you invest in this area, or if you build a plant over here, or if you produce the right kind of widget, you get a tax break. And so I cannot give you an answer about how their system exactly works in practice. I think they collect a slightly lower share from corporations than we do, though.

Mr. DORGAN. Thank you very much. Let me ask you also about the testimony by Dr. Rahn on capital gains. I happen to think, especially more recently think, there may be a case you can make for a narrow band of capital gains treatment on specific kinds of venture capital, for example, but the broader capital gains treatment that we have had in this country, in my judgment, has been ill-advised. Dr. Rahn seems to suggest if we just keep moving this capital gains rate down, we get more and more revenue to the Federal government. He cites a number of studies to demonstrate that. I know those studies are subject to some controversy. What is your impression of those studies?

Mr. MCINTYRE. I think "subject to some controversy" is an understatement. As you heard today, the Treasury Department disagrees with these studies totally. So do we. One of the problems in this area is that when you put in a special break for capital gains, pretty soon there is an entire industry devoted to changing ordinary income into capital gains to get the break and the more the advantage, the more they work at it. So you may find a surge in capital gains because, all of a sudden, people who used to make wages or used to earn dividends are getting capital gains because of some smart tax shelter promoter. It is a kind of a false positive signal there where, yeah, people are going to try to convert their income to capital gains if you give them a break, we will revitalize the tax shelter industry, and that will make some people happy. But I do not think it will make the public happy and I hope it does not make the committee happy.

Mr. DORGAN. One final question. Thank you, Mr. McIntyre. Ms. Bourdette and Mr. Greenstein, do you have any reaction to the proposal in the options booklet on child care credit or do you recommend there be changes in the child care credit?

Ms. BOURDETTE. As we suggested in the testimony, it would be useful as an offset to any excise taxes to make the dependent care tax credit refundable. Because of the good changes in the tax reform bill last year, the dependent care tax credit is no longer of any value to low income working families who have no tax liability. We have, and Mrs. Kennelly on your committee has suggested many times in the past that it would be very helpful to make that

credit refundable. If that required capping it at the top, as is suggested in the pamphlet, that is a possibility.

Mr. DORGAN. Mr. Greenstein?

Mr. GREENSTEIN. I would just subscribe to the same answer Mary just gave.

Mr. DORGAN. My only concern about refundability is, you know, when you take that issue on its continuum, you come up to Charles Walker's level of refundability, which we saw in safe harbor leasing back in 1981. I am not as sold on that, perhaps, as some others might be. I appreciate your response. Mr. McIntyre, I appreciate your testimony and I think as we sort through this, getting testimony from many different interests on the whole range of alternatives, income taxes, excise taxes, and all of the features of both, that we are going to be able to come up with a consensus of raising revenue the most effective way, not only for the economy, but for individuals in this country. Thank you very much for your testimony.

Mr. PICKLE. Thank you, Mr. Dorgan. Mr. Moody?

Mr. MOODY. Thank you. I take it, Mr. McIntyre and others, from your comments already, that you would consider——

Mr. PICKLE. Mr. Moody, let me ask you to yield to Mr. Rangel and then I will come back to you next. Mr. Rangel has to leave.

Mr. MOODY. Sure.

Mr. RANGEL. Mr. Greenstein, your testimony was that you thought excise taxes—some were discretionary and some were not and that bothered me a little bit. Is it your testimony that a working man who takes a can of beer or drink of wine or shot of liquor or has a cigarette, that that is discretionary and therefore, you could support an excise tax on that, while someone in a higher income tax bracket, while it is still discretionary with them, it would have no impact on their conduct or the availability of the goods. That does not bother you at all?

Mr. GREENSTEIN. No, we are bothered by the regressivity of any excise taxes. I think what we are saying is that if it is necessary, our preference would be for a total revenue package that was progressive all the way through. If that is not possible and it is necessary to include some excises in the package, we think that could be acceptable if, *(a)* they were modest, *(b)* they were on those items that were more discretionary than others, and even so, with a working man having a beer, it is still more discretionary than the telephone or heating his home. And third, if there were offsets for low and moderate income families, if any of those three did not entail, if the excises were larger and not modest, if there were no low or moderate income offsets, and if we started getting into major excise taxes on nondiscretionary items, we would have much more difficulty with it. Our first choice would be to not have excises in there.

Mr. RANGEL. This discretionary thing, is that a word of ought not when it comes to beer and cigarette and liquor taxes?

Mr. GREENSTEIN. I believe that recent studies, such as those by the Congressional Budget Office, show the percentage of people in various income categories, such as below $10,000, $10,000 to $20,000, who incur various kinds of excise taxes, telephone, energy, beer, wine, cigarettes, and so forth. And that percentage is much

lower for the alcohol and tobacco than it is for the telephone and energy, which are close to 100 percent, in terms of the percentage of people in those income brackets who incur them. So that is the only point we are trying to make there.

Mr. RANGEL. Well, you normally make your points much clearer than the way you are making this one and it would seem to me that you and the tradition of your association, would be very vigorously opposed to any of these type of excise taxes and that you should not just determine the percentage of poor that decide that they want to do things that the average American would do. I have no idea how many cocktail parties you are forced to attend as a result of your responsibilities on the Hill, but some of the people that you are charging this up to be discretionary, may consider this just a part of the small comforts that they have in life, just by being poor. And it would really bother me if somebody that was not suffering the pain at all, decided somewhere, probably in the Congressional Budget Office, that for poorer people, this was a discretionary thing, but for other people, it was just a cost of doing business or a part of one's culture. I suspect that it was not too long ago that some people might have considered the telephone to have been discretionary and a variety of other things that just depended on how many people used it. In any event, your groups have been very, very active over the years in effective legislative changes concerning tax policy, and I hope that we can depend on you now as we reach some decisions. Is there anyone here that truly believes that the President is going to sign any tax package, no matter what we do?

Mr. MCINTYRE. I do.

Mr. RANGEL. You believe the President would be prepared to sign?

Mr. MCINTYRE. It has happened before. I can recall in 1982, the President was "in concrete" against any tax increase, but Congress passed a lot of corrections to fix up things in the income tax, and he called that a revenue enhancement and he signed it. In 1984, the same thing happened. You can go back to California in 1971, when he signed income tax withholding for the State. He had campaigned saying I am "in concrete" against this and when he signed the bill, he looked out at the reporters and said, and "now I feel it cracking." The President can change his mind. I think he is playing a negotiation role right now with the Congress and he has done it over and over, and I think that he is going to sign something.

Mr. RANGEL. So you think the Congress should present him the most responsible piece of legislation that we can because it could become the law of the land?

Mr. MCINTYRE. I think that is absolutely right.

Mr. RANGEL. Do your partners on the panel believe that this President is prepared to sign a tax law?

Mr. GREENSTEIN. If you asked me to rate the chances, I would say less than 50/50, but I do not think zero. I think it is possible. I think this relates in part to the question of Gramm-Rudman and to what degree defense expenditures, which are near and dear to his heart, are threatened by the failure to sign a reconciliation bill. I think, in the absence of that kind of relationship, there is probably no chance, with that some chance. Still less than 50/50.

Mr. RANGEL. So the position of your associations would be that you think that the Congress should do the responsible thing and attempt to raise the revenue in order to reduce the deficit?

Mr. GREENSTEIN. Yes.

Ms. BOURDETTE. Absolutely. The Children's Defense Fund also agrees that additional revenue is absolutely essential. We hope you will develop and craft a bill that the President will sign, but certainly one that is done in a responsible way to show the American people——

Mr. RANGEL. And you will keep records of those members who would not take this responsible position, I assume?

Ms. BOURDETTE. We do have a voting record, yes.

Mr. RANGEL. Very good. Thank you.

Mr. PICKLE. And now, Mr. Moody.

Mr. MOODY. Thank you. You heard the previous witnesses inveigh against raising the corporate income tax or personal income tax or delaying reduction of personal income tax, in fact, any tax which, as they put it, would "break faith with the 1986 tax reform package." I assume you heard them talk in those terms. However, the same witnesses went on to suggest we need a reduction in the capital gains tax. Would you consider that change to also break faith with the 1986 tax reform package? You may respond in any order you wish.

Mr. MCINTYRE. I think, totally, that to cut the capital gains rate, as they have suggested, would undermine what the Tax Act achieved in terms of the progressivity in the income tax and I think that is the goal of those who propose such a change. I mean, these people who talk about breaking faith, they were against the bill. We are the ones who were for it, along with the members of the committee here, because there was a public need to restore some fairness to the tax system. Cutting capital gains taxes in half does not restore fairness. It undermines the fairness of the system.

Mr. MOODY. I was not on this committee during the deliberations of the 1986 tax bill, so I am not sure. Are you telling me that NAM and the Chamber of Commerce were opposed to the tax reform bill?

Mr. MCINTYRE. Almost to the end. I think, finally, they signed on when it was a foregone conclusion that it was going to pass.

Mr. MOODY. In any event, my narrow question is, do you think that opening up the package for capital gains would be just as much a breach in faith?

Mr. MCINTYRE. It would be a much bigger breach of faith. The public supported the bill ultimately, because they thought that General Electric and General Dynamics and John D. Rockefeller and so forth, were going to start paying taxes. To reinstate a capital gains differential would mean that the tax shelters would be back and that the public would be disappointed in their hopes.

Mr. MOODY. Any disagreement from the other witnesses?

Mr. GREENSTEIN. No, and I think the arguments that cutting the capital gains rate to 15 percent will increase, rather than decrease, revenue. They are akin to the arguments that we heard in 1981 that the supply side tax cuts there would reduce the deficit. It did not work then and it would not work now.

Mr. MOODY. I am sorry, I did not mean to cut you off. One possible package that I can foresee that might have some interest is some change in the capital gain tax, some reduction in turn for a constructive realization at death. A tremendous amount of capital gains are never taxed, despite the 1986 reforms, because they are simply revalued upwards at death to the current market value; therefore, escape capital gains taxes whatsoever. Constructive realization never takes place. Now, there is a problem with family farms and you probably have to exempt them. Is this a preference or a tax break which any of you find attractive to close?

Mr. MCINTYRE. In our testimony, we suggested that taxing capital gains on inherited property would be a fair and equitable way to raise revenues.

Mr. MOODY. Do the others agree? I do not want to take more time than I have to.

Mr. GREENSTEIN. Yes, we would very much agree with that.

Mr. MOODY. Would any of you be interested if there were, as a trade-off, some adjustment in the capital gains tax that would go hand-in-hand with that because it might be tough politically to do that without something to go with it.

Mr. MCINTYRE. The first issue I ever worked on before this committee was in 1976, involving estate tax reform. And a deal was cut that year in which State taxes were reduced and a carryover basis on inherited assets was enacted. Carryover basis never went into effect. The last time I was involved in cutting a deal like that, it did not work out. So it makes me very nervous.

Mr. MOODY. I see.

Mr. GREENSTEIN. I would add, in Bob McIntyre's testimony on this issue, capital gains on inherited assets, he notes that special rules for farms and small businesses could be drafted to deal with some of the problems in those areas. I think that would be a much better way to go than coupling this with a reduction in the rate.

Mr. MOODY. In other words, provide relief for small business, family farms, that sort of thing?

Mr. GREENSTEIN. Rather than reducing the capital gains tax rate for everybody.

Mr. MOODY. Let me shift the focus for my remaining time to the question of excise taxes. I have noted the very helpful table from Mr. McIntyre's presentation regarding the regressivity. Again, you may reply in any order you wish. I noticed that when you are using Mr. McIntyre's table on page 2, that the point at which the 1986 tax cut is less than the tax increase from these excise taxes, and these are pretty hefty excise taxes, that they total the whole $20 billion rather than some fraction of the $20 billion. But assuming you want the whole boat, so to speak, all excise taxes, which is highly unlikely. Assume you did, and that it breaks between $20,000 to $30,000 and then $30,000 to $40,000. At that point, the 1986 tax cut becomes smaller than the tax increase. In other words, people on a net basis, are slightly disadvantaged, comparing those two actions. But $20,000 to $30,000 and $30,000 to $40,000 covers pretty broad spectrums. Can you tell me at which point the tax becomes larger?

Mr. MCINTYRE. It is in the low $40,000's. It is around $42,000, $43,000.

Mr. MOODY. So people lower than $42,000 would be slightly disadvantaged and after that they would be disadvantaged.

Mr. MCINTYRE. Above $42,000 they would still retain some of their benefits from the 1986 act.

Mr. MOODY. Well, no, they would——

Mr. MCINTYRE. Again, it dips again.

Mr. MOODY. Above $42,000 they would have a net loss, it seems to me.

Mr. MCINTYRE. Right. Below $42,000 they would lose and above that, they would gain, in general, although even in that large $50,000 to $200,000 group, especially between $75,000 and $100,000, there are a lot of losers there, too.

Mr. MOODY. Right. Well, maybe you could give me the cutoff point. The main part of my question is, can you give us numbers or specific figures on the earned income tax credit or other device, as you might suggest, that would effectively alleviate this problem? Maybe if the other two of your would comment on this?

Mr. KAHAN. Mr. Moody, one of the problems you would have is that if you were to go the whole vote on excise tax, you couldn't effectively counteract when the income tax reached its own. It's a subset of the working poor population. There would be many other poor people who would not be reached by any measure you could choose.

Mr. MOODY. Even refundable?

Mr. KAHAN. Even refundable earned income tax credit would only reach the working few. Nonworking poor such as the elderly——

Mr. MOODY. Some wouldn't file, they wouldn't know how to file and so forth?

Mr. KAHAN. Some people wouldn't file. Some people who didn't have income. So you would really be very hard pressed to find a way to complete that.

Mr. MOODY. Let me rephrase the question. Let's take a perhaps more realistic scenario where half of the $20 billion, let's say $10 billion, slightly over half of the 19.3, is raised by excise taxes.

Would we be able to alleviate most of the regressivity through earned income tax credit or other device?

Mr. KAHAN. I think you really would be challenging the creativity of the Joint Tax Committee to come up with a measure that could reach people who aren't in the income tax system as a way of offsetting the regressive effects.

Excise taxes would hit hard working poor; would hit people who don't file income taxes, and you would be hard pressed to get to those people to give them back the money you were taking away.

Mr. GREENSTEIN. I think that as the amount of excise taxes in the package become more modest, the ability to do an offset that covers the working poor and doesn't leave too big burdens uncovered, for the others increases. It's going to be difficult once you get up in the $10, $11, $12 million range.

Mr. MOODY. Right. So if you are in the 6 to 7, you might have a pretty good shot at wiping it out.

Mr. GREENSTEIN. It becomes much easier when you're in that kind of range, that's right.

Ms. BURDETTE. And as you know, we have suggested several proposals to adjust the earned income tax credit.

Mr. MOODY. The slope of the line.

Ms. BURDETTE. Right. Some that would be made available to all families who are eligible; others that would be made available to larger families. So you can adjust even within that what types of families you're trying to target.

Mr. MOODY. It seems to me that if you are trying to propose regressivity on a consumption base tax, you would want to take into account family size—consumptions proportionate to family size.

Mr. GREENSTEIN. That would be yet another reason in addition to the ones we mentioned in the testimony.

Why I think we would agree that the first thing to look at—there are several options that we think are useful—the single most important one to look at first would be the adjustment of the EITC by family size. In addition to increasing the phase-in rate, the 15 percent and making the dependent care tax credit refundable. Those latter two are also most likely smaller in cost than the family size adjustor.

Mr. MOODY. OK. Thank you very much.

Mr. PICKLE. Mr. Levin.

Mr. LEVIN. Thank you.

Let's spend a few more minutes on the excise taxes. Your testimony has been most helpful. And I think small nuances may make a big difference. So let me just press you without forcing you to overstate your positions at this point. Because I think there is some difference in emphasis among you on excise taxes, and it was reflected in some of the comments here. And we're going to be arguing this, and I think arguing it out.

Let's not assume excise taxes for the full $20 billion. I don't see that happening. We're talking about some lesser amount, and maybe I should ask Mr. McIntyre if you want to comment a little more on the flavor in the testimony from Bob Greenstein and Mary Burdette.

How much do you feel they are wrong?

Mr. MCINTYRE. The differences are small. They say that if we have to have excise taxes, they would rather they were on alcohol and cigarettes. Because they think they might be able to influence the behavior of low income people to stop using these things.

It's probably true. People would run out of money eventually and they can't buy something.

But, I think that the idea that the committee is going to make social policy this summer rather than raise revenues is probably not a very good one. And particularly—I think Congressman Rangel hit on it—what you're saying to low-income people is you can't enjoy yourself in these viceful ways, but everybody who makes plenty of money can because they don't care. I'm just not sure that the role of Congress is to tell people what small vices they ought to enjoy. Particularly when these taxes are so regressive.

Mr. MOODY. Would the gentleman yield?

Just quickly, isn't there an argument that low income people are much more apt to have their health costs borne by others than

upper and middle income persons. So there is a countervailing argument here. People in the low end of the income spectrum are more apt to be on Medicaid than people who are in the upper income end. So, the fact that they decide to consume cigarettes is a health factor, which costs us all in a way that rich people are less likely to. I think that's the countervailing argument.

Mr. MCINTYRE. I think all those arguments are there, but I think ultimately it comes down who is going to pay the taxes that the committee raises this summer, and that's my main concern.

Mr. LEVIN. But you're not opposed to tax policy reflecting social policy, are you?

Mr. MCINTYRE. I get real nervous about tax policy trying to influence behavior. That's how we got all the loopholes that were in the code before the Reform Act. Congress tried to encourage people to do this and discourage them from doing that, and we had a Tax Code that looked like swiss cheese.

My hope is that the committee will focus mainly on raising revenues in a fair way.

Mr. LEVIN. Fair means relates to social policy, doesn't it?

Mr. MCINTYRE. Well, I guess there is a social policy in assessing taxes based on ability to pay them. But if you can achieve that particular goal, I think you're better off than trying to meddle with other ones.

Mr. LEVIN. Let me just push you for one second because Bob Greenstein referred to a CBO table, and Mr. Rangel reacted to it. But we are going to be talking about it so we might as well do a little of it here.

The CBO study shows, I think, contrary to the image that a lot of people have, that for families with income less than $5,000, only about a third spend any money on beer. Well, for those in the $50,000 bracket, it's 91 percent.

Now, isn't there some relevance to that?

Mr. MCINTYRE. I think you ought to look at the 5 to 10 category. Below 5 is a kind of an aberrational category.

Mr. LEVIN. Well, then, 5 to 10, it's 44 percent versus 91 percent for those $50,000 or more?

Mr. MCINTYRE. I think that's probably fair, that people at that low level don't drink as much as people who are richer. And, nevertheless, the share of their income on average, including the nondrinkers, is much higher. So I don't know where that leads you, other than to say, well, we're only going to affect half of these people, but that half is going to be hit really hard. And so maybe they don't vote. I don't know.

Mr. LEVIN. No. In fact, I think you might argue that your table is in a sense understated because where a smaller percentage utilize beer, the five-tenths of 1 percent is much higher for a percentage.

Okay. We will all be talking much more about that. That's where the word "discretionary" comes from. And I think it's not unfair to make that point.

Let me just ask you quickly. On the rates, you said, well, there's a new situation. We have a deficit. But don't you think when Congress passed the tax reform bill and the President signed it last

year, we knew there would be a major deficit this year? I mean there really isn't a change in circumstances, is there?

Mr. McINTYRE. Well, last year, there wasn't a mandate to raise revenues. This year there is. That's the change.

I think that the 1986 bill was drafted in part to give this committee and the Congress the opportunity to freeze the rates if that looked like an appropriate route to take. And I think that a freeze or even just extending the 33 percent rate so that it doesn't apply only to the near rich but also to the very rich is something that ought to be on the table in this Committee.

Mr. LEVIN. But do you think that was within the contemplation of Congress and the President? When most people voted for it, they thought that the——

Mr. McINTYRE. Before the bill passed, the Chairman of this Committee gave a speech—before it was signed, I should say—gave a speech in which he advocated higher income tax rates.

Mr. LEVIN. All right. Let me just go on quickly and ask you, and I'll be done, Mr. Chairman, to give us any further information or ideas you have on business meals, why you think it would be equitable to make another change, how that's worked out. You mentioned newspaper reports, but there is better data than that, I think.

Also your special rules for farms and businesses, all show—it seems to me the committee needs to look at the actual experience with home equity loans. On those three points relating to your interesting suggestions, we need further information.

Thank you, Mr. Chairman.

[The following was subsequently received:]

Reply by Robert S. McIntyre to Rep. Levin's questions:

1. Business meals: According to the newspaper reports I mentioned in my testimony, neither businessmen nor restaurant owners report any significant adverse impact on the restaurant industry as a result of the limit on deductions for business lunches to 80 percent of what's spent.

For example, *The Wall Street Journal* of July 17, 1987 includes a front-page story titled "Despite the Tax Law, People Get Hungry and Put In for Lunch." The story notes:

> "[Things aren't] exactly the picture of gloom seen by the restaurant industry when it was fighting the new tax law last year. The industry lost the battle, but . . . [b]usinessmen and restaurateurs say the new law, which reduced tax deductions for business meals, isn't keeping people from having lunch. . . .
>
> "[T]he National Restaurant Association financed a Chase Econometrics study that concluded the new law would bring disaster: 342,000 lost jobs and a reduction of $8.9 billion in the industry's $200 billion annual sales. Now however, nearly six months later, the association says members are reporting 'very little' change in sales."

A February 28, 1987 *New York Times* story, titled "Tougher Business Tax Rules Fail to Dampen Entertaining," tells a similar story:

> "Remember all that talk about darkened theaters and shuttered restaurants when Congress was voting last year to restrict the deduction for business entertainment and meals, the corporate world's everyday tax break?
>
> "Well, from the long reservations lists at the Four Seasons and La Caravelle and other favorites of the expense-account set in New York and elsewhere, nothing appears to have changed. Nor could one tell from the brisk sale of seats for Broadway shows and of season box tickets for the Mets, Yankees and other baseball teams. . . .
>
> "Apparently undaunted by the tighter tax rules—under which only 80 percent of most entertainment and meal expenses are deductible instead of the full amount—executives and sales representatives are continuing to spend billions of dollars wining and dining clients and customers.
>
> "While precise figures have not been calculated since the new rules went into effect Jan. 1, the spending seems as free as before, even though the Government is now picking up less of the tab."

The full text of the two stories quoted above is attached.

2. Special rules for farms and small businesses in connection with taxing capital gains on inherited property: If Congress were to impose taxes on built-up capital gains in inherited property, the problems of family farms and small businesses might be dealt with by deferring the tax until the inherited property is actually sold (or the heirs stop running the farm or family business). In other words, in the case of family farm or small businesses, the heirs would take a "carryover basis" in the inherited property, rather than pay a tax on the capital gains immediately.

3. Home equity loans: The staff of the Joint Committee on Taxation estimates that eliminating the deductibility of interest on home equity loans (by limiting mortgage interest deductions to acquisition indebtedness) would raise $1.7 billion in fiscal 1989 and $1.8 billion in fiscal 1990.[1] These amounts represent about six percent of the total revenue loss from mortgage interest deductions estimated by the staff for those years in its most recent analysis of tax expenditures.[2]

Since most mortgage interest deductions reflect home purchases over a considerable period of time, while home-equity loan interest deductions reflect only recently incurred debt, the staff's estimates indicate that the home-equity share of the total *new* mortgage market is much higher than six percent—perhaps 25 percent or more.

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[1]See Joint Committee on Taxation, *Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means* (JCS-17-87), June 25, 1987.

[2]See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1988-1992* (JCS-3-87), February 27, 1987. The staff estimates the total revenue loss from all mortgage interest deductions to be $28.4 billion in fiscal 1989 and $29.6 billion in fiscal 1990.

The Wall Street Journal, June 17, 1987, page 1:

Despite the Tax Law, People Get Hungry And Put In for Lunch

* * *

Curtailed Deduction Brought Restraint, but Not Much; Eating Out in Hollywood

By KATHLEEN A. HUGHES
Staff Reporter of THE WALL STREET JOURNAL

It is just past noon and Joan Rivers is holding forth at a corner table at Le Dome, a favorite entertainment-industry lunch spot in Los Angeles. Outside, a white Rolls-Royce is surrounded by many Mercedes-Benzes. Besides Miss Rivers, a number of executives are enjoying their expensive lunches.

This isn't exactly the picture of gloom seen by the restaurant industry when it was fighting the new tax law last year. The industry lost the battle, but Le Dome is still going strong, and it is no exception. Businessmen and restaurateurs say the new law, which reduced tax deductions for business meals, isn't keeping people from having lunch.

"Tax reform doesn't bother me at all, and I turn deaf ears to my accountant," says Tom Korman, the vice president for television at Agency for the Performing Arts Inc., who has just polished off a $45 lunch (vodka on the rocks, then halibut) with agent Ben Pearson. "I get hungry every day at 12:30," he says. "Lunch is convivial."

Predictions of Disaster

The change in tax treatment, which went into effect in January, reduced the allowable deduction for a business meal to 80% from 100%. A bearable change, perhaps, but the National Restaurant Association financed a Chase Econometrics study that concluded the new law would bring disaster: 342,000 lost jobs and a reduction of $9.9 billion in the industry's $200 billion annual sales.

Now, however, nearly six months later, the association says members are reporting "very little" change in sales. So what happened?

There are psychological factors that the study couldn't take into effect, says Jeffrey Farner, the group's director of association relations. The group says it expects the new law to hurt sales next year after corporations have truly felt the tax change, that is, after they have filed their tax returns for 1987.

Some accountants agree. "We haven't seen very much impact on restaurants at all," says Jay Brandzel, the national tax partner of Laventhol & Horwath, a Philadelphia accounting firm that specializes in restaurants. "But when companies get around to filing their tax forms and seeing the impact on their bottom lines, it's going to have a negative impact on restaurants. Smaller companies are going to be surprised."

Less of a Bargain

Mr. Brandzel says that many companies will discover that a $100 business lunch has cost them $73, up from $54 last year, after all the tax changes are taken into account.

In some cases, too, tax reform is riding piggyback on corporate cost-cutting programs. "Tax reform is happening at the same time that cost control has become a corporate creed," says A. Gary Shilling, a New York economic consultant. "But it isn't having a huge impact. People aren't saying, 'Let's have cold cuts and warm beer.'"

Indeed, some executives willing to have their lunch interrupted by a reporter wax eloquent about the many purposes served by eating out on the company. Trying to chat in the office, they say, is too difficult. The phones ring. Large desks induce formality and define power relationships. Besides, everybody has to eat.

And nowhere, it seems, is lunch taken more seriously than in Hollywood, where the prospect of multimillion-dollar deals dwarfs the price of business meals, no matter how costly. In fact, the most ag-

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Despite New Tax Law, Eating Out On the Company Is Still Popular

Continued From First Page

gressive Hollywood executives, mindful of the possibilities, often have *two* breakfasts with different business contacts, one at 7:30 and the other at 9. They then have lunch, drinks and dinner—all business occasions—to look forward to.

One such heavy business eater is Bertrand Schneiderman, the president of Ron Ilon Enterprises, an entertainment services company with offices in New York and Los Angeles. "I sometimes have two breakfasts, one lunch and, occasionally, drinks with one party and dinner with another," says Mr. Schneiderman, who also keeps residences on both coasts. "It helps maximize my stay in Los Angeles."

Mr. Schneiderman notes that while he attends two breakfasts, all he has is coffee.

However, those in charge of corporate penny-pinching in Hollywood and elsewhere aren't ignoring the tax changes. Accountants say many companies have sent out memos urging lunch-hour restraint.

Some are getting much nosier about who the lunch guest was and just what got discussed. "Companies are asking more questions like, 'Why did you go to lunch for $400?'" says Stanley Ross, a co-managing partner of Kenneth Leventhal & Co., a Los Angeles accounting firm.

But top brass are more interested in maintaining business relationships than they are in a 20% drop in a tax deduction. John Burnham, a vice president at William Morris Agency in Beverly Hills, says the firm called a special meeting and asked employees to be more mindful of meal expenses following the tax change. But Mr. Burnham, who represents actress Diane Keaton, among others, says he still has a minimum of 13 business meals a week. However, he says, "I try to be more prudent in ordering a particular bottle of wine."

Meals do have rewards having nothing to do with food. Mr. Burnham says that one of his clients, the movie producer Art Linson, made a pitch over a breakfast of scrambled eggs that he produce "The Untouchables." Ned Tanen, the president of Paramount Pictures Corp.'s motion-picture group offered him a six-figure deal on the spot. The movie, just released, is a big box-office hit.

Lunch is so important in Hollywood that big shots sometimes are urged to eat out more often. An executive at a large Hollywood studio says a superior recently phoned him to advise: "You could be spending more money on lunch."

The Meaning of Lunch

"Lunch is a sacred institution," says the executive, who is back up to five lunches a week. "There's a perceived correlation between the money you spend at meals, the status of the people you are lunching with and the quality of your work."

Of course, lunch doesn't have to be fun just because an employer or someone else is picking up the check. Eating out, done often enough, can lose its savor. Stuart Robinson, a Hollywood literary agent, says he generally endures two business breakfasts, four business lunches and two business dinners a week, and he hasn't cut back this year. "Truthfully," he says, "it gets a little routine." He adds: "I don't want to make it sound burdensome. There are people who are working in coal mines and in garbage trucks."

In some industries, of course, executives are facing smaller lunch allowances. Howard Weise, a sales manager at the furniture maker Knoll International, said his travel and entertainment budget has been cut by about 20%. That didn't stop him, however, from inviting two of his clients and a prospective client to lunch at Trumps, an expensive Los Angeles restaurant. The prospect, Houry Aposhian, an executive vice president of Pacific Plaza Financial Corp., an Irvine, Calif., mortgage banking operation, wants to furnish about 14,000 square feet of office space.

Mr. Weise says the subject of lunch came up because he had just finished his sales pitch and it would have been "embarrassing not to invite them." But there is some question whether the $112 lunch for four clinched a deal for Knoll. Ms. Aposhian says that over lunch she learned that she and Mr. Weise have friends in common. The luncheon party also chatted about children and phone bills.

Comparison Shopping

It all made Ms. Aposhian well disposed toward Mr. Weise—but she has yet to buy furniture from Knoll. "I'll spend a couple of weeks, see some other furniture and then decide," she says.

The heaviest lunchers clearly are those who talk a lot for a living: people in the movie business, advertising, the communications business and sales. But even the owners of small businesses say they aren't cutting back. Anne Plumb, who owns a New York gallery, recently spent $120 there on lunch at a Manhattan restaurant entertaining artist Gregory Botts, an art critic and the curator of a Pennsylvania gallery. The group enjoyed steak and french fries and pleasant conversation about art, San Francisco and Philadelphia.

"I don't think about tax reform," says Ms. Plumb, who has lunch out two or three times a week, usually with artists or gallery owners. "The whole little routine of lunch is a nice thing to do."

Of course, not everyone thinks so. Some people deliberately avoid business lunches for reasons having nothing to do with tax deductions. Robert Stern, a well-known New York architect, says he eats cottage cheese and fruit in the office. "I'm a solid at-my-desk fellow," he says. "If you go to a restaurant, it's 20 minutes of chitchat and perusing the menu. Who has time for that in life?"

The New York Times February 28, 1987,
Saturday, Late City Final Edition

Section 1; Page 1, Column 1;
Financial Desk

TOUGHER BUSINESS TAX RULES FAIL TO DAMPEN ENTERTAINING

Remember all that talk about darkened theaters and shuttered restaurants when Congress was voting last year to restrict the deduction for business entertainment and meals, the corporate world's everyday tax break?

Well, from the long reservation lists at the Four Seasons and La Caravelle and other favorites of the expense-account set in New York and elsewhere, nothing appears to have changed. Nor could one tell from the brisk sale of seats for Broadway shows and of season box tickets for the Mets, Yankees and other baseball teams.

Business 'as Good as Ever'

"I was a little worried about it, but right now I am relieved," said Andre Soltner, owner of Lutece. "Business is as good as ever."

Apparently undaunted by the tighter tax rules—under which only 80 percent of most entertainment and meal expenses are deductible instead of the full amount—executives and sales representatives are continuing to spend billions of dollars wining and dining clients and customers.

While precise figures have not been calculated since the new rules went into effect Jan. 1, the spending seems as free as before, even though the Government is now picking up less of the tab.

"It hasn't really sunk in yet," said Albert Ellentuck, national tax partner at the accounting firm of Laventhol & Horwath, a specialist in advising small and medium-size companies. "I think it's inevitable that there will be some tightening up later because companies will be seeing that it's going to cost more."

But for now, "it's basically business as usual," according to Donald Tannenbaum, managing partner of the accounting firm of Oppenheim, Appel, Dixon & Company. "The additional cost is just going to be a cost of business."

Such is the case at the Tonka Corporation, a toy manufacturer that has not changed its expense-account policies despite the change in the law. "We already try to manage that type of expense to the point where it is necessary for business," said Stephen G. Shank, the company's president and chief executive."I have not heard this as being a matter of high concern at other companies."

"It's important for people to be in contact with each other," said William P. Madar, president and chief executive of the Nordson Corporation, an Ohio industrial products company, which has not changed its policies, either. "The tax changes can't swing these decisions. You just roll it over and pay the taxes at the end of the day."

Change in Expense Forms

So far, one of the few visible signs of the changes has been the introduction by hundreds of companies of new forms to keep track of different types of employee expenses. The forms typically have separate listings for expenses that are fully deductible, 80 percent deductible or nondeductible.

The new law "turns out to be more of an aggravation in terms of recordkeeping than a burden on expenses," said John V. Roach, president and chief executive of the Tandy Corporation.

The 20 percent reduction in deductibility is not the only change under the new rules, part of the sweeping Tax Reform Act of 1986. The value of the deduction is further diminished because of lower corporate income tax rates, pushing up the real cost to a company of entertainment and meal expenses by 35 percent. For example, a $200 bill for dinner and theater that used to cost a company $108 after taxes costs $145.60 under the new law.

Moreover, the new rules require that business be a major topic of discussion during the meal. Under the old law there was no requirement that business affairs even be touched on, although there had to be a business purpose for having the meal in the first place.

The changes are expected to save the Government some $11.1 billion over the next five years, according to the Treasury Department's Office of Tax Policy.

A recent survey by the American Express Company found that travel, entertainment and meal expenses are the third-largest expense at most companies, trailing only salaries and data processing. At least $90 billion was spent by businesses on meals and entertainment in 1986, according to the survey.

During the tax debate in Congress last year,

restaurateurs, theater operators and sports promoters lobbied vigorously to retain full deductibility, forecasting dire consequences if the proposed changes became law. Now, however, some industry groups concede that their fears may have been unwarranted, at least for the short term.

A Chase Econometrics study commissioned by the National Restaurant Association, for example, predicted that the industry could lose as many as 342,000 jobs and $8.9 billion in sales this year because of the change. The industry has eight million full- and part-time jobs and revenues of $200 billion.

"We have not begun to feel it yet," Jeffrey R. Prince, senior director of the Washington-based association, said of the projected drop in sales. "It's our hope that even though it costs more to continue these meals, companies won't reduce them because they are important to their businesses."

Similarly, neither professional sports organizations nor theater operators have reported a drop in ticket sales.

'Selling to Capacity'

"We have shows that are selling to capacity," said Arthur Rubin, general manager of Nederlander productions, owners of theaters in New York. Mr. Rubin said that at the time the tax proposal was debated, "We obviously said it would hurt us because we were trying to defeat the bill." He cautioned that it remained difficult to assess the long-term effects.

"I don't believe that the new tax laws will have an impact on the sale of season tickets," said A. Bartlett Giamatti, president of the National League. "What will determine baseball ticket sales is how well the teams are doing."

The Mets, for instance, coming off their victory in the World Series last year, expect to surpass last season's record sales of more than three million tickets. And the Yankees, who did not have quite as winning a record, report that season-ticket sales are up more than 20 percent over the comparable period last year.

"I know it will be more costly for corporations," said Harvey Greene, spokesman for the Yankees," but as long as we stay competitive we'll do good business."

Mr. Giamatti said that in recent meetings with officials of teams in the Midwest and on the Pacific Coast, no one expressed concern that the new tax laws would hurt sales. Last season, businesses accounted for about 45 percent of the purchases of season passes. It remains too early to tell the effect of the Tax Reform Act on the sale of sky boxes, those luxurious rooms in sports stadiums and arenas that often contain televisions and bars, because the deduction for them under the new rules is sharply reduced over the next three years.

Cutbacks May Still Be Ahead

Though the effect of the tax change has been negligible so far, some observers say companies will start to cut back on entertainment and meal expenses over the next year or so.

"As a matter of economic theory, the lower rates and higher expenses should mean cuts," said A. Gary Shilling, an economic consultant. "Our clients are taking a hard look at it, but these things don't get changed overnight."

He said that most 1987 company expense budgets were set before the new tax rules were enacted.

"I think it will be a gradual shift," Mr. Shilling said. "We may start to see it next year or in the second half of this year. It's a serious concern, but it's more in the 'to do' stage than in the 'do now' stage."

Mr. PICKLE. Mr. Guarini, we're pleased to recognize you at long last.

Mr. GUARINI. Thank you, Mr. Chairman.

You've expressed the uniform opinion of raising revenues as a necessity and, of course, many of us agree with you on that, and that the tax should be a progressive tax. And I assume that you would rather not revisit tax reform again or change the marginal rates.

Is that a correct assumption?

Mr. MCINTYRE. We suggested freezing the 1987 top rate which would revisit the rates, I suppose.

Mr. GUARINI. So that you would want to restructure the rates that we passed last year in tax reform after we have changed the tax laws four times in the last 6 years? Do you think that it would give that much certainty and that much comfort to our business world and to our industry and manufacturing world that we should then make another change and let businessmen have less planning opportunity as a result of another reform of our rates?

Mr. MCINTYRE. I think anybody who is counting on the tax rates staying this low for any length of time is making a poor business decision.

Mr. GUARINI. You don't think that the business community should be able to depend on a Congress that gives them stability in their tax rates?

Mr. MCINTYRE. I wish that we could keep the rates stable, Mr. Guarini, but, unfortunately, the budget deficit hangs over us. And it seems to me if you're going to address the deficit, you're going to have to look at closing loopholes or raising rates, or both.

Mr. GUARINI. Well, there are a lot of different ways to go.

For instance, no one has mentioned estate taxes. Now, from what I see happening in our country today, we have an ungodly accumulation of money. Never before have there been so many billionaires, especially in the field of real estate where there have been so much depreciation taken that many of the wealthiest people in our country never paid any taxes at all. We're familiar with that.

Now, having that much money certainly doesn't have any good social purpose. When you pass that much money down, and people just clip coupons, you don't have any productivity on the part of the people that are inheriting billions of dollars. And we do have that happening in our society today.

Do you think we should reexamine our estate tax laws and that we should change our tax laws so that we have the same progressivity, and that people, after they have earned a large sum of money, can pass on to their heirs certainly a comfortable future, but not be able to pass billions and billions of dollars on generation after generation because we virtually phased out our estate tax laws.

What is your opinion on that?

Mr. MCINTYRE. We have suggested a couple of reforms in the estate tax area in our testimony, and we would like to endorse your statement 100 percent. We agree with you, The estate tax ought to be revitalized.

Mr. GREENSTEIN. We would agree with that also.

Mr. GUARINI. Yes. Anyone else?

Mr. GREENSTEIN. We would agree with that also and with your statement. We do think estate taxes is definitely one of the areas——

Mr. GUARINI. Estate and gift taxes.

Mr. GREENSTEIN. Yes, to revisit this year.

Mr. GUARINI. Right. Now, in regard to the progressive tax, I haven't heard much said about a surtax or luxury tax. Now, we repealed our luxury taxes, I believe, last in 1965. We call on luxury taxes in times of emergency. This would get at the fur coats, at the Mercedes-Benz, at the wealthier end of our spectrum.

What is your opinion of the luxury tax?

Mr. MCINTYRE. According to the staff estimates, there's apparently not a lot of money in the luxury tax proposals. Other than that, we have no objection to it.

Mr. GUARINI. What do you think, Mary?

Ms. BURDETTE. We very much support reimposition of the luxury tax while recognizing, as Mr. McIntyre does, that it is not going to produce a lot of revenue. Nevertheless, we think it's an important direction to move in.

We also would like you to look at other things, as we mentioned in the testimony, such as lowering or abolishing the deduction for business meals and entertainment expenses. We would like you to look at a range of options that might be levied on those with more income.

Mr. GUARINI. Is the objection to a luxury tax based on the administering and the managing of a luxury tax that it might give a lot of leeway for cheating and be difficult to collect?

Ms. BURDETTE. We have no objection.

Mr. MCINTYRE. If there were an objection, it's that it may not raise enough money to justify the apparatus needed to collect it.

Mr. GUARINI. All right. Now, what about a very simple added apparatus to collect, a surtax? A person pays a 5-percent surtax on say $10,000 of his income tax bill so he pays an additional $500 for 3 years.

Now, what is your opinion about that? It's just another line on the income tax form, costs nothing to collect. Everyone is progressive. It fits your criteria. What is your opinion about a surtax?

Mr. MCINTYRE. I think a surtax is one of the things that we would support. It's similar to rate increases which we have endorsed in our testimony.

Mr. GUARINI. The rest of the panel?

Mr. GREENSTEIN. I would make two statements.

On the one hand, now that the tax system has been reformed, a surtax would be far more equitable than it would have been before the Tax Reform Act of 1986. And from a substantive standpoint, we could support it.

From a political standpoint, I think if you go the surtax route, you may make it easier for the President to go on TV and say see they are raising everybody's income taxes, which I understand that, dealing with the rates, seems to be going back to part of last year's act, but at least dealing with the top rate doesn't allow him to say you're raising everybody's income taxes.

Mr. GUARINI. Where would you kick it in, Mr. Greenstein? Would you kick it in on every individual that has a tax bill, or

would you go above those who were $1,000, $5,000 or $10,000 in taxes? At what level would you have a surtax?

Mr. GREENSTEIN. What I'm saying is I think—I hadn't really thought of a surtax that applied at some income levels and not at others. I suppose one could do that. That would be a possibility.

Mr. GUARINI. That would be getting to the more wealthy and the people who can afford to pay the tax. An excise tax would hit the other end of the spectrum——

Mr. GREENSTEIN. It would enable you to keep the rates where they are or have the surtax at the top of the income scale. I think that might be a possibility. I haven't really thought about it that much.

Mr. GUARINI. Mr. McIntyre, have you thought about it?

Mr. MCINTYRE. Oh, yes. That's exactly what we suggested with the higher rate at the top, I mean effectively the same thing. And we agree with it, with your position, and we agree with our position. That's why we put it in the testimony.

Mr. GUARINI. Should there be an exemption at a certain level?

Mr. MCINTYRE. I would not apply a surtax until you got to the high income levels.

Mr. GUARINI. At what level of income would you apply it then?

Mr. MCINTYRE. I think roughly at $150,000 to $200,000 is the appropriate cutoff point. That I think, is where the money is, and is where the gain in progressivity is needed, and would raise enough money to meet the budget targets.

Mr. GUARINI. Did you run the numbers on $150,000?

Mr. MCINTYRE. Well, if you added a surcharge, and it depends on the rate, of course, you could raise—let's say if you did it $200,000 with a surtax that amounted to 5 percent of income. So I guess that's roughly——

Mr. GUARINI. It wouldn't get to very many people though.

Mr. MCINTYRE. It wouldn't get many people You're affecting about 1 percent of the population and you'd raise about $10 billion a year.

Mr. GUARINI. I don't think you'd collect that much money though.

Mr. MCINTYRE. The joint tax estimate on a 33 percent rate extended is, when phased in, $8.8, billion and then the next year——

Mr. GUARINI. That's above a $10,000 payment of income tax though, not $200,000.

Mr. MCINTYRE. Above $20,000 in income is what they did.

Mr. GUARINI. Yes. All right. Thank you.

Mr. PICKLE. Now, Mr. Pease, would you like to inquire?

Mr. PEASE. Yes, Mr. Chairman, I would. Thank you very much.

Mr. Chairman, I would like first to commend the entire panel for their statements but, in particular, Mr. McIntyre, who has made some extraordinarily useful suggestions.

I want to say at the outset that I agree with your principles. I think the committee would be well advised to follow those principles in drafting a bill.

I also agree with you that the committee really ought to look upon this exercise not as a burden, but as an opportunity to continue the movement toward tax reform that we started last year.

I would like to ask a couple of things.

Mr. Dorgan, about a month or so ago, produced a report by a task force that he set up—a task force that included two former Commissioners of the IRS. They estimated, if I recall correctly, that if we were to put $3.5 billion over the next 5 years into taxpayer assistance and taxpayer compliance, that we could get in as much as $105 billion, which is a pretty remarkable return on such an investment.

Mr. McIntyre, you did not include anything of that sort in your list of recommendations. I'm wondering if you could tell us whether you think there is a reasonable prospect for getting revenue from this source, probably not in the first year, but in subsequent years, and if you think if it is possible for scorekeeping purposes to quantify how much money we could get from any given amount of increased attention to compliance?

Mr. MCINTYRE. Well, Mr. Pease, we support the direction of Congressman Dorgan's report. We think it's a good idea. I'm not sure it's in the jurisdiction of the committee this month to increase spending on the IRS, or we would have put it in our testimony, because we think that's one of the things that ought to be explored and ought to be done, if not this year, then soon.

Mr. PEASE. Well, Mr. McIntyre, appropriating more money for the IRS is not in the jurisdiction of this committee. We would have to work out an agreement that any savings that would result from an increase in appropriations could be scored against the entire $19.3 billion, and that we would get credit in the aggregate, if not for that specific bill.

Frankly, a problem that Mr. Dorgan has had and that I have had in being an enthusiastic supporter of his concept is that CBO and the Joint Tax Committee look upon these yield numbers as sort of spongy. And as you know how things operate around here, there has to be a score. And the official scorekeepers have to say if you do "X", you will produce "Y" result.

Do you think it's possible, using conservative assumptions, to come up with some quantifiable result from given an increase in expenditures?

Mr. MCINTYRE. They did it for Senator Packwood last year. Of course, nobody believed it. It's a problem, getting an estimate on that. And my advice would be to come in with a low estimate, whatever they will give, and that if it raises more money, then your job gets a lot easier in the future.

Mr. PEASE. What about Speaker Wright's suggestion for a tax securities transactions? Could you comment on that?

Mr. MCINTYRE. We used to have one, the United Kingdom has one, Japan has one, West Germany has one. It doesn't seem to have caused any of their economies to fall.

I think it's an idea you ought to explore. It was repealed back in the general effort to get rid of all those kinds of taxes at the Federal level, which was generally a good move. With the anti-excise tax movement in the sixties, the securities transactions tax went out. But maybe it should come back. It's certainly a lot easier to collect these days than it was back then.

Mr. PEASE. Is there reason why you did not include it in your list of recommendations?

Mr. MCINTYRE. I guess I ran out of time. But it's in my new Republic article.

Mr. PEASE. How about progressivity enhancement? You mentioned those, and I agree with you that there's no particular need to reduce the top marginal rate from 70 percent to 28 percent in a 6-year period.

Do you think we could structure progressivity enhancements in a way to yield significant revenue in the first year?

Mr. MCINTYRE. The first year is the hard part for any income tax change. But then it raises a lot in the future years. So if you're looking at the 3-year target, it's very effective.

It's hard to get much the first year just because of the tax filing season being outside the fiscal year. There's not too much you can do about that. But income tax reform was done in 1982, and the 1982 bill is still raising $40 billion a year. It's a remarkable achievement.

Mr. PEASE. Thank you very much.

Mr. PICKLE. I thank the panel very much for your testimony and for your response to the questions.

Mr. DORGAN. Mr. Chairman, could we clear up one statistic, please, just briefly?

Mr. McIntyre, on the subject of the 5 percent surtax, I just wanted to clear up that issue. My understanding was that the 5 percent surtax generally applied would raise about $10 billion for individuals and $3 billion for corporations.

Mr. MCINTYRE. I was talking about a 5 percent of income surtax rather than a 5 percent of tax.

Mr. DORGAN. Surtax.

Mr. MCINTYRE. You could restructure it as a surtax version but it would be higher than 5 percent.

Mr. DORGAN. A very big difference.

Mr. MCINTYRE. Absolutely.

Mr. DORGAN. Okay. Thank you very much.

Mr. GUARINI. Point of information.

Then when I was asking a question on surtax, you were talking about a 5 percent marginal rate increase, not on a surtax?

Mr. MCINTYRE. You could style that as a surtax. I was unable to do the arithmetic in my head, but I guess it would be about 18 percent or something like that.

Mr. GUARINI. But you are talking about changing the rates. It's a different discussion than a surtax.

Mr. MCINTYRE. Well, you can turn a rate change into a surtax. In other words, if you want a five point rate change, five twenty-eights is an 18 percent——

Mr. GUARINI. You're dealing with numbers. All right.

Thank you.

Mr. PICKLE. Thank you very much.

Our next panel is Christopher Lardis, president, Trumbull County, Ohio, Board of Commissioners; the Honorable Frank Cooksey, mayor of Austin, Tex.; the Honorable Patrick Sweeney, majority whip, Ohio House of Representatives; Richard Stifter, assistant director, UC/WC activity, General Motors Corp., accompanied by William R. Brown; and Patricia Dix, legislative specialist, National Education Association.

If you panelists would take your seats.

This panel consists of Christopher Lardis representing the National Association of Counties. Mr. Lardis.

Then we have our friend, the able mayor from Austin, Tex., Frank Cooksey, mayor of Austin, the best city in the United States today.

Then Patrick Sweeney, majority whip of the Ohio House, representing the National Conference of State Legislatures.

Then Richard Stifter, who is assistant director of General Motors Corp., and you are accompanied by Mr. William Brown. Is he with you?

Mr. STIFTER. He's with me, sir.

Mr. PICKLE. Then we have Ms. Patricia Dix, representing the National Education Association.

We'll start then in the order listed, Mr. Lardis.

Before we start, let me ask do any of you individuals have plane reservation times? Do any of you need to be recognized and excused, or can you set through the panel? We regret that there has been such a great number of witnesses today, but we're just moving as quickly as we can.

We'll proceed in order then. Mr. Lardis, will you start?

All of your statements will be included in the record in their entirety.

Mr. Lardis.

STATEMENT OF CHRISTOPHER LARDIS, PRESIDENT, TRUMBULL COUNTY, OHIO, BOARD OF COMMISSIONERS, REPRESENTING THE NATIONAL ASSOCIATION OF COUNTIES

Mr. LARDIS. Thank you, Mr. Chairman, members of the committee. It's an honor to be here before the Congress. Coming in from the provinces I believe gives us an opportunity to give you an idea of what it's like back there under some very difficult economic conditions.

I represent the National Association of Counties today. And I would like to say this. We strongly support the effort to reduce the Federal deficit, and we support the effort through a combination of tax increases and equitable spending reductions. To this end, our association has supported and lobbied for adoption of the current budget resolution.

We believe that the Federal Government should be financed predominantly by personal and corporate income taxes based on a progressive rate structure that reflects a taxpayer's ability to pay, and promotes the equitable distribution of resources nationwide. We therefore are not opposed to an extension of the 1987 tax rate schedules for both individuals and corporations through 1988, or for a longer period if necessary. Nor are we opposed to the creation of a third or even a fourth marginal tax rate at the higher income tax levels.

Our county association also supports an increase in the many excise taxes, such as alcohol, tobacco, luxury and firearms in order to supplement the income tax for deficit reduction. In other words, those who can afford to pay ought to pay it.

However, where Federal tax increases are used for deficit reduction, our association urges Congress to acknowledge that direct partnerships between Federal, State, and local governments, as well as the historical precedent, and I believe this is important, of intergovernmental reciprocal tax immunity and not raise revenues by taxing State and local governments.

If the Congress intrudes into areas where we depend upon our source of income, then we are going to have some very serious problems. We fear mandates, and with due respect to my colleague on my right, we have an awful lot of mandates coming from the State capitol. Additional mandates from the Federal Government is going to present a real problem to the local governments.

Our association opposes an increase in the gasoline tax when used for deficit reduction because this undermines the concept of a user based fee trust fund predicated on a pay as you go basis by the users of our highway system. This particularly undermines our intergovernmental system by threatening a traditional and long standing source of revenue for State and local governments. Furthermore, it hits low income working class families the hardest and unfairly asks the motoring public to shoulder the burden of the deficit.

The National Association of Counties has serious reservations about the Federal Government moving toward a national sales tax as a primary source of funding. Historically, State and local governments have relied on this base as a major source of financing for public services. Preemption of this tax base by the Federal Government would have serious consequences for future State and local revenue raising capacity.

Mr. Chairman, the one aspect that concerns us in the counties, and bear in mind that here in America the people are moving out into the woods and into the mountains, or what I describe as the county areas. We are having more and more citizens come out there. We have the responsibility to bring water and sewers, police protection and so forth, and we're finding it very difficult. We just do not have the vehicles to bring about those necessary things that people want in their environment. And the quality of life will suffer in the counties if we don't have the wherewithal to do it, or if we don't have the help of the Federal Government.

The one mandate that concerns us is the Medicare mandate. And I consider the mandate, and it will be an additional cost on our shoulders. Now, for my county, this Medicare requirement, if I may, sir, amounts to only $262,708 a year. But let me tell you what the problem is. When I get a call from a widow in the middle of the night that she sees a vagrant in her backyard, and I don't have a police car or a police officer to send out there, I'm saying to you we have suffered a serious degradation of our quality of life.

This $262,000 would permit the purchase of several police cars and the hiring of several deputies. In my county today, we have a deficit of $3 million, which doesn't sound like much. But let me tell you just how badly it affects us. We have no mosquito control program, although the medical people tell us that, in our area, encephalitis and human heartworm might be carried by those mosquitoes.

We have 39,000 people in the county without police protection. We have a building the State built for our juveniles. It's a juvenile

rehabilitation center. We do not have the money to buy the furniture nor to pay the utilities. And today we don't know if we're getting a full pound of hamburger on our scales or a full gallon of gasoline because we have really laid off all of our people who checked on those equipments.

We do have some serious problems, and I would like very much to ask your help in going easy on us with respect to any mandates.

Thank you very much, sir.

[The statement of Mr. Lardis follows:]

NATIONAL
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IMPACT OF THE PROPOSAL TO EXPAND MANDATORY MEDICARE COVERAGE TO INCLUDE ALL STATE AND LOCAL GOVERNMENT EMPLOYEES

STATEMENT OF

CHRISTOPHER LARDIS

PRESIDENT, TRUMBULL COUNTY BOARD OF COMMISSIONERS

TRUMBULL COUNTY, OHIO

ON BEHALF OF

THE NATIONAL ASSOCIATION OF COUNTIES

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

July 7, 1987

THANK YOU, MR. CHAIRMAN, FOR INVITING ME TO PARTICIPATE IN THE COMMITTEE'S HEARING ON PROPOSALS TO INCREASE REVENUES. I AM CHRISTOPHER LARDIS, PRESIDENT OF THE TRUMBULL COUNTY, OHIO, BOARD OF COMMISSIONERS AND I AM TESTIFYING ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES.*

THE NATIONAL ASSOCIATION OF COUNTIES (NACO) STRONGLY SUPPORTS EFFORTS TO REDUCE THE FEDERAL DEFICIT, THROUGH A COMBINATION OF TAX INCREASES AND EQUITABLE SPENDING REDUCTIONS. TO THIS END NACO SUPPORTED AND LOBBIED FOR ADOPTION OF THE CURRENT BUDGET RESOLUTION.

WE BELIEVE THAT THE FEDERAL GOVERNMENT SHOULD BE FINANCED PREDOMINATELY BY PERSONAL AND CORPORATE INCOME TAXES BASED ON A PROGRESSIVE RATE STRUCTURE THAT REFLECTS A TAXPAYER'S ABILITY

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* THE NATIONAL ASSOCIATION OF COUNTIES IS THE ONLY NATIONAL ORGANIZATION REPRESENTING COUNTY GOVERNMENT IN THE UNITED STATES. THROUGH ITS MEMBERSHIP, URBAN, SUBURBAN, AND RURAL COUNTIES JOIN TOGETHER TO BUILD EFFECTIVE, RESPONSIVE COUNTY GOVERNMENT. THE GOALS OF THE ORGANIZATION ARE TO: IMPROVE COUNTY GOVERNMENT; SERVE AS THE NATIONAL SPOKESMAN FOR COUNTY GOVERNMENT; ACT AS LIAISON BETWEEN THE NATION'S COUNTIES AND OTHER LEVELS OF GOVERNMENT; AND ACHIEVE PUBLIC UNDERSTANDING OF THE ROLE OF COUNTIES IN THE FEDERAL SYSTEM.

TO PAY AND PROMOTES THE EQUITABLE DISTRIBUTION OF RESOURCES NATIONWIDE. WE THEREFORE ARE NOT OPPOSED TO AN EXTENSION OF THE 1987 TAX RATE SCHEDULES FOR BOTH INDIVIDUALS AND CORPORATIONS THROUGH 1988 OR FOR A LONGER PERIOD IF NECESSARY. NOR ARE WE OPPOSED TO THE CREATION OF A THIRD OR EVEN A FOURTH MARGINAL TAX RATE AT THE HIGHER INCOME LEVELS. NACO ALSO SUPPORTS AN INCREASE IN THE MANY EXCISE TAXES, SUCH AS ALCOHOL, TOBACCO, LUXURY AND FIREARMS, IN ORDER TO SUPPLEMENT THE INCOME TAX FOR DEFICIT REDUCTION.

HOWEVER, WHERE FEDERAL TAX INCREASES ARE USED FOR DEFICIT REDUCTION, NACO URGES CONGRESS TO ACKNOWLEDGE THE DIRECT PARTNERSHIPS BETWEEN FEDERAL, STATE, AND LOCAL GOVERNMENTS AS WELL AS THE HISTORICAL PRECEDENT OF INTERGOVERNMENTAL RECIPROCAL TAX IMMUNITY, AND NOT RAISE REVENUES BY TAXING STATE AND LOCAL GOVERNMENT.

I NOW WISH TO ADDRESS THE PROPOSAL TO EXPAND MANDATORY MEDICARE COVERAGE TO INCLUDE ALL STATE AND LOCAL GOVERNMENT EMPLOYEES. AS YOU ARE AWARE, IN 1985, WITH ITS OWN DEFICIT LOOMING LARGE, CONGRESS DETERMINED THAT IT WOULD BE APPROPRIATE TO CHANGE ITS LONGSTANDING POLICY OF ALLOWING STATE AND LOCAL GOVERNMENTS TO DETERMINE WHETHER PARTICIPATION IN THE MEDICARE SYSTEM WAS THE BEST WAY TO ASSURE THAT THEIR EMPLOYEES RECEIVED ADEQUATE HEALTH CARE AFTER RETIREMENT. INSTEAD, IN THE CONSOLIDATED OMNIBUS BUDGET RECONCILIATION ACT OF 1985,

CONGRESS MADE MEDICARE COVERAGE MANDATORY FOR STATE AND LOCAL GOVERNMENT EMPLOYEES. HOWEVER, APPARENTLY, RECOGNIZING BOTH THAT COVERAGE OF ALL EMPLOYEES WOULD IMPOSE A SUDDEN AND HARSH FISCAL BURDEN UPON THE GOVERNMENTS THAT EMPLOY THEM, AND THAT COVERAGE OF THE ENTIRE WORK-FORCE WOULD BE IN PLACE IN A SHORT-TIME PERIOD THROUGH JOB TURNOVER IF NEWLY HIRED WORKERS ALONE WERE COVERED, CONGRESS ADOPTED THAT PHASE-IN METHOD. AS A RESULT, COVERAGE IS NOW REQUIRED ONLY FOR EMPLOYEES HIRED ON OR AFTER APRIL 1, 1986. THE VERY PROPOSAL NOW UNDER CONSIDERATION WAS REJECTED WHEN PROPOSED LAST YEAR FOR INCLUSION IN THE OMNIBUS BUDGET RECONCILIATION ACT OF 1986.

THE REASONS SUPPORTING ADOPTION OF COBRA'S PHASE-IN PROVISION ARE MORE COMPELLING THIS YEAR. THE MANDATORY COVERAGE PROPOSAL ARISES AGAINST THE FOLLOWING BACKDROP. MANY COUNTY GOVERNMENTS NATIONWIDE ARE IN A STATE OF FISCAL CRISIS AND, FOR SOME, THERE IS NO END IN SIGHT. REQUIRING THESE GOVERNMENTS SUDDENLY TO PAY 1.45% OF THEIR ENTIRE PAYROLL IN NEW MEDICARE TAXES WOULD EXACERBATE THEIR PROBLEMS. IN MOST CASES, THE TERMINATION OF THE GENERAL REVENUE SHARING PROGRAM, COMBINED WITH LOCAL ECONOMIC DRAINS HAS CREATED A SOMETIMES-DESPERATE SITUATION, RESULTING IN DRASTIC MEASURES. FOR EXAMPLE:

- O WASHINGTON COUNTY, LOUISIANA, ENTIRELY ELIMINATED ITS ELDERLY HOMEBOUND MEALS PROGRAM.

O BARRY COUNTY, MISSOURI, CLOSED ITS HEALTH DEPARTMENT AND CUT ITS SHERIFF'S BUDGET BY HALF.

O CHIPPEWA COUNTY, MICHIGAN, DROPPED ITS CRIPPLED CHILDREN'S PROGRAM AS WELL AS ITS HOME HEALTH CARE SERVICES.

O LEE COUNTY, KENTUCKY, WHICH IS THAT STATE'S SECOND LEADING OIL PRODUCER, HAS SUFFERED FROM LOW OIL PRICES AND WILL LOSE $400,000 IN OIL SEVERANCE-TAX MONEY. LEE COUNTY ALSO LOST $112,000 PER YEAR IN FEDERAL REVENUE SHARING AND TODAY SUFFERS AN UNEMPLOYMENT RATE OF MORE THAN 20 PERCENT.

O CUYAHOGA COUNTY, OHIO, REDUCED ITS SUBSIDY TO THE COUNTY HOSPITAL BY $5 MILLION.

O PACIFIC COUNTY, WASHINGTON, HAS HAD A DECREASE IN FOREST PRODUCT REVENUES WHICH CONSTITUTED NEARLY 40 PERCENT OF THE COUNTY'S OPERATING RESOURCES SIX YEARS AGO AND NOW ONLY PROVIDES 3 PERCENT OF LAST YEAR'S RESOURCES, A LOSS OF NEARLY TWO MILLION DOLLARS A YEAR. PACIFIC COUNTY ALSO LOST ANOTHER QUARTER MILLION DOLLARS EACH YEAR AS A RESULT OF THE TERMINATION OF THE FEDERAL REVENUE SHARING PROGRAM.

o IN HOT SPRING COUNTY, ARKANSAS, THE AMBULANCE SERVICE IS NO LONGER PUBLIC OR FREE: AN UNEXPECTED TRIP TO THE HOSPITAL NOW COSTS AS MUCH AS $250.

o RITCHIE COUNTY, WEST VIRGINIA, HAS EXPERIENCED A FALTERING GAS AND OIL INDUSTRY AND WILL LOSE $193,000 OR 25 PERCENT OF ITS TOTAL REVENUES. LAST YEAR RITCHIE COUNTY LOST OVER $200,000 IN FEDERAL REVENUE SHARING FUNDS. COUPLED WITH THESE LOSSES, THE COUNTY HAS ALSO EXPERIENCED A $5 MILLION REDUCTION IN PROPERTY ASSESSMENTS AND IS TERMINATING POSITIONS IN ITS LAW ENFORCEMENT DEPARTMENT ALONG WITH OTHER COUNTY SERVICE DEPARTMENTS.

o AS A RESULT OF THE LOSS OF REVENUE SHARING, LOS ANGELES COUNTY, CALIFORNIA, CLOSED SEVEN PUBLIC HEALTH CENTERS, ELIMINATED SEVEN HEROIN DETOXIFICATION LOCATIONS, AND DECREASED THE NUMBER OF WELFARE DEPARTMENT EMPLOYEES BY 1,000, AMONG OTHER CURTAILMENTS.

THESE FISCAL PROBLEMS ARE ONLY THE TIP OF THE ICEBERG AND ARE ESPECIALLY ALARMING BECAUSE COUNTIES, AS THE FASTEST GROWING JURISDICTIONS IN MOST STATES, ARE ALSO THE "GOVERNMENT OF LAST RESORT." COUNTIES ARE RESPONSIBLE FOR THE NATION'S GROWING DEMAND FOR CRITICAL HEALTH AND HUMAN SERVICES AS WELL AS THE MAINTENANCE OF MUCH OF THE COUNTRY'S INFRASTRUCTURE.

AT THE SAME TIME, THEY ARE FORCED TO RELY ON THE MOST REGRESSIVE FORM OF FINANCING -- THE LOCAL PROPERTY TAX. MANY COMMUNITIES FACE ECONOMIC AS WELL AS POLITICAL DIFFICULTIES WHEN THEY ATTEMPT TO RAISE THIS UNPOPULAR TAX. IN SEVERELY DISTRESSED COUNTIES, PROPERTY VALUES CONTINUE TO DECLINE AND SOME LOCAL GOVERNMENTS HAVE BEEN FORCED TO RAISE TAX RATES TO OFFSET DECLINING TAX BASES. WORSE, MANY POOR COUNTIES HAVE REACHED THE HIGHEST PROPERTY TAX RATES ALLOWED UNDER STATE LAWS. ALTHOUGH COUNTIES ARE LOBBYING THEIR STATES FOR INCREASED TAXING AUTHORITY, THEY HAVE ACHIEVED LIMITED SUCCESS IN DOING SO.

LET ME GIVE YOU SOME BACKGROUND INFORMATION ABOUT MY OWN COUNTY, TRUMBULL, SO THAT YOU CAN SEE HOW IT WOULD BE AFFECTED BY THE MANDATORY MEDICARE COVERAGE PROPOSAL.

TRUMBULL COUNTY IS A SMALL BEDROOM COMMUNITY FOURTEEN MILES OUTSIDE OF YOUNGSTOWN, OHIO. THE COUNTY'S FISCAL YEAR '87 BUDGET IS $13,122,438. FEDERAL REVENUE SHARING LOST BY TRUMBULL COUNTY IN 1986 AMOUNTED TO $889,446, WHICH AMOUNTED TO 7 PERCENT OF OUR TOTAL BUDGET -- NOT AN INSIGNIFICANT AMOUNT.

AT RECENT BUDGET HEARINGS, EACH DEPARTMENT HEAD TESTIFIED THAT AN EMERGENCY FISCAL CONDITION EXISTS IN THE COUNTY, AFFECTING THE HEALTH, WELFARE, AND SAFETY OF THE CITIZENS. THIS EMERGENCY SITUATION EXISTS DUE TO A $3,104,888 SHORTFALL

IN THE 1987 COUNTY BUDGET. IN REAL LIFE TERMS WHAT DOES THIS DOLLAR SHORTAGE MEAN?

SINCE 1981, TRUMBULL COUNTY IS DOWN FROM 431 to 241 EMPLOYEES, REPRESENTING A SIGNIFICANT BELT-TIGHTENING EFFORT AND A GREAT COST TO GOVERNMENT EFFECTIVENESS. NOT ONLY ARE 241 EMPLOYEES NOT ENOUGH TO RUN A COUNTY OF ABOUT A QUARTER OF A MILLION PEOPLE, BUT THE COSTS OF LAYING OFF THESE EMPLOYEES HAS BEEN HEAVY. IN 1987 ALONE THE COUNTY WILL PAY $435,950 IN UNEMPLOYMENT COMPENSATION. SINCE 1981 WE HAVE SPENT $744,893 ON LAID-OFF WORKERS.

THERE ARE NOW 39,000 CITIZENS IN THE UNINCORPORATED AREAS OF TRUMBULL COUNTY WHO HAVE NO POLICE PROTECTION. FURTHERMORE, THE SHERIFF HAS 430 OUTSTANDING WARRANTS, MANY OF WHICH ARE FELONY CHARGES. HE SERVED ONLY NINE OF THESE WARRANTS DURING THE MONTH OF MAY, DUE TO A SHORTAGE OF DEPUTIES.

THE ELDERLY AFFAIRS PROGRAM WILL CLOSE DOWN FOR LACK OF FUNDS AND OUR CHILD ASSAULT PROTECTION UNIT WILL BE CLOSED EARLY NEXT YEAR PLACING ABUSED AND NEGLECTED CHILDREN AT THE BOTTOM OF THE LIST IN TERMS OF PROTECTION BY GOVERNMENT AUTHORITIES.

IN THE PROSECUTOR'S OFFICE, THERE IS NO JUVENILE PROSECUTOR, NO FULL TIME CRIMINAL DIVISION HEAD, NOR A COURT OF APPEALS PROSECUTOR.

THE COUNTY WILL NOT BE ABLE TO INSTITUTE A MOSQUITO CONTROL PROGRAM. DISEASES SUCH AS HUMAN HEART WORM AND ENCEPHALITIS CAN BE CARRIED BY MOSQUITOES. THERE IS NO PREVENTIVE INOCULATION FOR HUMAN HEART WORM.

THE COUNTY'S WEIGHTS AND MEASURES TEAM HAS BEEN DISBANDED. THEREFORE, INSPECTORS ARE NO LONGER CHECKING GASOLINE PUMPS AND GROCERY SCALES. CITIZENS NO LONGER KNOW WHETHER THEY ARE GETTING A FULL GALLON OF GAS OR A FULL POUND OF HAMBURGER AT THE GROCERY STORE.

A BACKLOG OF 10,000 DOCUMENTS IN THE RECORDER'S OFFICE IS SLOWING DOWN REAL ESTATE TRANSACTIONS AND MORTGAGE DOCUMENTS. INABILITY TO OBTAIN DOCUMENTS OR OWNERSHIP HURTS THOSE HOPING TO COMPLETE FINANCIAL ARRANGEMENTS. MORTGAGE FIRMS, LENDING INSTITUTIONS, AND CREDIT COMPANIES ARE FINDING IT DIFFICULT TO DO BUSINESS IN TRUMBULL COUNTY. SOME WILL NOT DO BUSINESS HERE, SLOWING DOWN BUSINESS INVESTMENT, AND COSTING US JOBS.

FOR SEVEN COUNTY BUILDINGS WE HAVE ONLY SIX MAINTENANCE/JANITORIAL EMPLOYEES TO MAINTAIN CLEANLINESS, FIX

LIGHTS, PLUMBING, CLEAR SNOW, CUT AND WATER GRASS; WE HAVE ONLY THREE BOILER-AIR QUALITY TECHNICIANS FOR SEVEN BUILDINGS.

COUNTY BUILDINGS ARE DETERIORATING AS THERE HAS BEEN LITTLE OR NO MAINTENANCE IN MANY YEARS. THE LACK OF FUNDS HAS PRECLUDED FIXING LEAKY ROOFS, OUTDATED PLUMBING AND HEATING SYSTEMS; AND WORST OF ALL, THIS POOR FINANCIAL CONDITION HAS PERMITTED OLD AND UNSAFE ELECTRICAL SYSTEMS TO GO WITHOUT MAINTENANCE CAUSING SERIOUS SAFETY HAZARDS. THE PEOPLES' INVESTMENT IN THE COUNTY INFRASTRUCTURE IS CONSIDERABLE AND SHOULD NOT GO UNATTENDED.

TRUMBULL COUNTY IS IN FACT IN CRISIS. WE ARE LOSING POTENTIAL INVESTORS AND DEVELOPMENT DUE TO THE LACK OF PUBLIC INVESTMENT IN OUR COMMUNITY. THERE IS ONLY ONE WAY OUT -- MONEY. THE COUNTY HAS ATTEMPTED TO END THE DEFICIT. WE HAVE BORROWED $284,514 FROM THE INSURANCE FUND AND HAVE PUT ON THE AUCTION BLOCK BOTH THE NURSING HOME AND AN HISTORICAL STONE BUILDING.

TWICE NOW WE HAVE GONE TO THE VOTERS WITH A HALF PENNY EMERGENCY SALES TAX AND THEY HAVE VOTED IT DOWN. WHY? THE MAJORITY OF OUR RESIDENTS ARE UNEMPLOYED OR UNDEREMPLOYED DUE TO THE LONG TERM FALL-OUT OF THE LOSS OF THE STEEL INDUSTRY, OR THEY ARE ELDERLY, BECAUSE THE YOUNG HAVE MOVED AWAY SEEKING MORE PROMISING OPPORTUNITIES. WE JUST DO NOT HAVE THE TAX BASE.

THE MANDATORY COVERAGE PROPOSAL WOULD COST TRUMBULL COUNTY $262,708 IN NEW MEDICARE TAXES IN FISCAL 1988. I CAN ONLY THINK WISHFULLY OF WHAT WE COULD DO WITH THAT AMOUNT IN OUR COUNTY. YOU CAN SEE THAT THERE IS SIMPLY NO SOURCE FROM WHICH WE CAN RAISE THIS REVENUE, NOR ANY PROGRAMS THAT WE CAN POSSIBLY BE EXPECTED TO CUT FURTHER. IN FACT, IF THIS PROPOSAL IS ENACTED, I ESTIMATE THAT WE WILL BE REQUIRED TO LAY OFF AN ADDITIONAL 15 EMPLOYEES FROM OUR WORK FORCE.

SINCE 1978, THE FEDERAL GOVERNMENT HAS INCREASINGLY WITHDRAWN FROM DOMESTIC POLICY AND HAS NOW VIRTUALLY TURNED ITS BACK ON COMMUNITIES LIKE MINE, SLASHING ITS FISCAL SUPPORT TO STATE AND LOCAL GOVERNMENTS BY 66 PERCENT. AT THE SAME TIME, FEDERAL MANDATES IMPOSED BY CONGRESS OR THE COURTS CONTINUE TO DICTATE TO STATE AND LOCAL GOVERNMENTS THE EXPENDITURE OF SUBSTANTIAL MONEY ON NATIONAL PRIORITIES SUCH AS WASTE WATER CONTROL, TOXIC WASTES, AND THE LIKE. COUNTIES LIKE MINE HAVE REACHED A POINT OF SERIOUS DISTRESS. CONGRESS MUST REALIZE THAT ADOPTION OF THE MANDATORY MEDICARE COVERAGE PROPOSAL WOULD COME ONLY AT A VERY HIGH PRICE, AND THAT STATE AND LOCAL GOVERNMENTS ARE BEING ASKED TO BEAR A DISPROPORTIONATE SHARE OF THE FEDERAL GOVERNMENT'S DEFICIT REDUCTION MEASURES. WE URGE CONGRESS INSTEAD TO RESPECT THE COMPROMISE STRUCK IN COBRA -- A PHASE-IN OF MANDATORY COVERAGE THROUGH COVERAGE OF NEWLY HIRED EMPLOYEES -- AND TO REJECT THE PROPOSAL TO EXPAND MEDICARE COVERAGE TO INCLUDE ALL STATE AND LOCAL GOVERNMENT EMPLOYEES.

MR. CHAIRMAN, I WOULD ALSO LIKE TO EXPRESS THE VIEWS OF NACO ON SEVERAL OTHER REVENUE RAISING OPTIONS WHICH NACO OPPOSES BECAUSE THEY REPRESENT EITHER AN INTRUSION INTO AREAS TRADITIONALLY CONSIDERED THE PREROGATIVE OF STATE AND LOCAL GOVERNMENTS, OR BECAUSE THEY REPRESENT AN UNFAIR FEDERAL MANDATE WHICH WILL ONLY RESULT IN A TAX SHIFT TO CITIZENS AT THE LOCAL LEVEL.

NACO OPPOSES AN INCREASE IN THE GASOLINE TAX WHEN USED FOR DEFICIT REDUCTION BECAUSE THIS UNDERMINES THE CONCEPT OF A USER BASED FEE TRUST FUND PREDICATED ON A "PAY AS YOU GO" BASIS BY THE USERS OF OUR HIGHWAY SYSTEM. IT ALSO UNDERMINES OUR INTERGOVERNMENTAL SYSTEM BY THREATENING A TRADITIONAL AND LONG STANDING SOURCE OF REVENUE FOR STATE AND LOCAL GOVERNMENTS. FURTHERMORE, IT HITS LOW INCOME WORKING CLASS FAMILIES THE HARDEST AND UNFAIRLY ASKS THE MOTORING PUBLIC TO SHOULDER THE BURDEN OF THE DEFICIT.

NACO OPPOSES REPEAL OF THE FEDERAL GASOLINE TAX EXEMPTION FOR STATE AND LOCAL GOVERNMENTS. THIS PROPOSAL IS A DIRECT VIOLATION OF THE CONCEPT OF INTERGOVERNMENTAL RECIPROCAL TAX IMMUNITY WHICH HOLDS THAT NO LEVEL OF GOVERNMENT SHALL TAX ANOTHER. JUST AS FEDERAL VEHICLES ARE EXEMPT FROM LOCAL TAXES, LOCAL GOVERNMENTS SHOULD BE EXEMPT FROM FEDERAL TAXATION.

NACO OPPOSES THE INCLUSION OF TAX EXEMPT BOND INTEREST AS A PREFERENCE ITEM IN THE ALTERNATIVE MINIMUM TAX (AMT). PROPOSALS TO EXPAND THAT TAX TO ALL BONDS AS WELL AS TO INCREASE THE AMT WHERE IT AFFECTS TAX EXEMPT BONDS REPRESENT A FLAGRANT AND DIRECT TAX ON STATE AND LOCAL GOVERNMENT AND THREATENS OUR ABILITY TO MARKET ESSENTIAL GOVERNMENTAL BONDS.

NACO OPPOSES REPEALING THE STATE/LOCAL PERSONAL PROPERTY TAX DEDUCTIONS. THE STATE AND LOCAL TAX DEDUCTION IS A CORNERSTONE OF INTERGOVERNMENTAL TAX POLICY.

NACO ALSO HAS SERIOUS RESERVATIONS ABOUT THE FEDERAL GOVERNMENT MOVING TOWARD A NATIONAL SALES TAX AS A PRIMARY SOURCE OF FUNDING. HISTORICALLY, STATE AND LOCAL GOVERNMENTS HAVE RELIED ON THIS BASE AS A MAJOR SOURCE OF FINANCING FOR PUBLIC SERVICES. PREEMPTION OF THIS TAX BASE BY THE FEDERAL GOVERNMENT COULD HAVE SERIOUS CONSEQUENCES FOR FUTURE STATE AND LOCAL REVENUE RAISING CAPACITY.

COUNTY GOVERNMENT STANDS READY TO WORK WITH CONGRESS AND TO SUPPORT YOU IN RESOLVING THE DEFICIT CRISIS. AFTER ALL IT AFFECTS ALL OF US. BUT, LET'S NOT JUST CONTINUE TO SHIFT THE BURDEN OF TAXATION AND NATIONAL RESPONSIBILITIES TO CITIZENS AT THE LOCAL LEVEL. THAT NOT ONLY IS UNFAIR, CREATING VAST DISPARITIES NATIONWIDE, BUT IT IS IMPOSSIBLE. LOCAL GOVERNMENTS RELY ON THE MOST REGRESSIVE TAX BASES, WHICH ARE

THE HARDEST TO RAISE. ALREADY MANY PUBLIC SERVICES, FROM EDUCATION AND HEALTH CARE TO BASIC INFRASTRUCTURE, ARE IN SERIOUS JEOPARDY.

STATE AND LOCAL GOVERNMENTS NEED THE FEDERAL GOVERNMENT TO WORK WITH US TO ENSURE A DECENT QUALITY OF LIFE IN ALL OF OUR COMMUNITIES ACROSS THE COUNTRY. WE LOOK FORWARD TO WORKING WITH YOU AND TO REBUILDING THE INTERGOVERNMENTAL PARTNERSHIP THAT HAS MADE THIS COUNTRY GREAT.

Mr. PICKLE. Thank you, Mr. Lardis.
Mayor Frank Cooksey, if you'll proceed.

STATEMENT OF HON. FRANK COOKSEY, MAYOR, AUSTIN, TEX., REPRESENTING THE NATIONAL LEAGUE OF CITIES

Mayor COOKSEY. Thank you, Mr. Chairman.

I am Frank Cooksey, mayor of Austin, Tex., home of one of the finest Congressmen in America. [Laughter.]

I am here this afternoon on behalf of the public officials of the National League of Cities, representing the Nation's cities and towns, and our fighters in the trenches for American competitiveness.

Our concern is to preserve our capacity to maintain our infrastructure for economic development and the amenities of life for the pursuit of happiness in our cities.

I want to thank you for permitting us the opportunity to represent our own taxpayers, the majority of whom live in cities.

Mr. Chairman, I want to say first that the National League of Cities endorses the House budget resolution. We respect your willingness to confront a very difficult issue and take a tough position on reducing the Federal deficit.

Second, we believe that the Federal Government ought to raise taxes to pay for any proposed spending increases. We believe the resolution addresses that issue. It is the way that we are forced at the city level to budget, and we believe in it.

None of us ever wants to raise taxes, but we recognized that when we have to cut spending to the level our taxpayers want, and if we don't do that, we must pay for the difference.

We're concerned, however, at revenue proposals which would interfere with our own budgets and our capacity to raise municipal taxes to meet our essential public services.

There are several proposals which would come under the jurisdiction of this committee which most directly concern and impact municipalities: mandatory Medicare coverage, mandatory Federal gas taxes for State and municipal vehicles, the elimination of the deduction for personal property taxes, and additional changes in the ability of municipalities to issue tax-exempt debt.

The proposal that municipalities and their employees should be required to contribute to the Medicare trust fund is one which this committee resolved more than a year ago when the Congress adopted legislation to phase in mandatory Medicare.

Having disposed of that issue, it is now back at your door, and I think it should not be. That should have resolved the issue. And I'm not going to say much more than that, other than the fact that in my city, for instance, mandatory Medicare would cost us approximately $700,000. Such an increase would require us to identify an offsetting municipal revenue that we would have to eliminate a program for our citizens or a tax increase. And we are in a situation right now in Austin, Tex., where we simply cannot afford that.

The Federal gas taxes. The proposal to repeal the exemption from Federal excise taxes for State and municipal vehicles would force cities and towns to increase their own taxes. Once again, in order to maintain current services for essential public services, in-

cluding police, fire, emergency rescue, and school bus transportation. In the city of Austin alone, this proposal would cost us $320,000 in our next budget year.

We do not have the alternative of cutting back on fuel use consumption or the purchase of trucks or other vehicles and parts. To do so would jeopardize the lives of our constituents and reduce public safety services.

The next item I would like to address is the personal property tax. We are very strongly opposed to any repeal of the personal property tax deduction. An 18.5 percent increase in our personal property taxes is necessary this year in Austin in order to balance our municipal budget. A repeal of this deduction would undercut our own efforts made in good faith and reliance on last year's tax bill.

For our citizens, it would mean a tax on income never received. But, most importantly, such a proposal would unravel the extraordinary effort our community has endured to produce a responsible deficit reduction plan in the city of Austin.

We are opposed to the proposal to reopen and impose still more restrictions and costs upon our authority and ability to issue debt.

We are especially concerned about proposals to impose still greater restrictions and costs upon our ability, capacity and authority to issue traditional municipal bonds. We are still awaiting mountains of IRS regulations to tell us how we must comply retroactively with the new law. An overwhelming number of our members believe that your committee, if it is going to consider any further changes, should only consider changes to facilitate our ability to provide traditional public purpose financing.

The options menu contains a number of suggestions to increase Federal taxes on the interest on traditional municipal bonds. And we are opposed to all of them. Among these are increasing the individual minimum tax from 21 to 26 percent; increasing the alternative corporate minimum tax; repealing the exemption from the individual minimum tax for general obligation and municipal revenue bonds; and reducing the State volume caps.

All of those we are opposed to, Mr. Chairman. And as I end my testimony, I would like to say that I am not one of these people personally, and here I'm leaving my testimony as an advocate for the National League of Cities, but I would like to say I am not one of these people who likes to come up here and say don't do this and don't do that, we know you've got a problem, but here I'm not going to give you any suggestions on what the best alternatives are.

I'd like to mention three and these are my personal comments at this point.

I think the securities transfer tax is an option which is opposed by Government Finance Officers Association because it does impact the pension fund. But I personally think that it's probably the least objectionable of the items that you're considering that have an impact on the municipalities.

I think another item which is, in my judgment, one that should be considered is raising the top marginal rate 30 percent. I personally believe you went too far in reducing the marginal rate in the top bracket.

I think also that doubling of the cigarette tax to 32 cents a pack would not be bad.

So those are some ideas that I think do have some merit. Of course it's your job to choose among them, and I understand that problem. It's one I'd really love to have because I don't have any options when I raise my tax bill. I've got one to raise and that's property tax.

[The statement of Mayor Cooksey follows:]

STATEMENT OF

THE HONORABLE FRANK COOKSEY

MAYOR, AUSTIN, TEXAS

on behalf of

THE NATIONAL LEAGUE OF CITIES

on

REVENUE INCREASE OPTIONS

before the

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

July 7, 1987

STATEMENT

OF

FRANK COOKSEY, MAYOR OF AUSTIN, TEXAS

July 7, 1987

Good afternoon, Mr. Chairman, I am Frank Cooksey, Mayor of Austin, Texas. I am here this afternoon on behalf of the public elected officials of the National League of Cities - the largest and oldest organization representing the nation's cities and towns.

I want to thank you for permitting us this opportunity to represent our own taxpayers, the majority of whom live in cities.

Mr. Chairman, I want to say first that the National League of Cities endorsed the House budget resolution. We respect your willingness to confront a very difficult issue and take a tough position on reducing the federal deficit.

Secondly, we believe that the federal government ought to raise taxes to pay for any proposed spending increases. We believe the resolution addresses that issue. It is the way we are forced to budget at the municipal level.

None of us ever wants to raise taxes, but we recognize that when we have cut spending to the level our taxpayers want, we must pay for the difference.

We are concerned, however, at revenue proposals which would interfere with our own budgets and capacity to raise municipal taxes to meet our essential public services.

In that respect we strongly oppose two of the federal tax increase proposals requested by the president, and we would oppose a number of the options suggested in the Congressional menu.

Our view on revenues has been and remains that we, as a nation, cannot afford to reduce individual and corporate tax rates until the deficit is reduces.

I know the situation you are confronting all too well. Due to revenue shortfalls from declining assessed property values and reduced sales tax receipts, we will be furloughing employees, delaying capital spending, and increasing personal property taxes in my city to make our budget balance.

Yet, a number of the tax options before you would undo our efforts, if adopted, by mandating new costs on our budgets or further reducing our already declining municipal taxes. I urge you in the very strongest terms to give the most careful attention to federal tax actions which could undercut the budgets of other levels of government in this country. Instead, we would urge you to focus on revenues which do not adversely impact the fiscal status of the nation's cities.

There are several proposals which would come under the jurisdiction of this Committee which most directly concern and impact municipalities: mandatory Medicare coverage, mandatory federal gas taxes for state and municipal vehicles, the elimination of the deduction for personal property taxes and additional changes in the ability of municipalities to issue tax-exempt debt.

Medicare

The proposal that municipalities and their employees should be required to contribute to the Medicare trust fund is one which this committee resolved more than a year ago when the Congress adopted legislation to phase in mandatory Medicare.

Having disposed of the issue, it is now back at your door. As proposed by the administration, the mandatory Medicare provision would take place in the middle of most state and muncipal budget years.

It makes no provision for how cities, with their budgets already in place, can make the transition from current health insurance systems to one mandated by the federal government. We anticipate that few, if any, cities or towns would have the flexibility to abruptly alter current medical benefit and retirement programs. Therefore, the only alternatives in most cases would be to increase property taxes or cut necessary expenditures.

In my city, for instance, mandatory Medicare would cost approximately $700,00, such an increase would require us to identify an offsetting municipal revenue or tax increase.

The bottom line is that our employees and our taxpayers would have to shoulder the full burden of this proposal on a very sudden basis.

I must add that this proposal comes at a time when municipalities have already been asked to bear disproportionate burdens. At the same time we have been asked to take such deep cuts, we have been required to assume major new financial responsibilities in the form of federal mandates. Meanwhile our own flexibility to raise revenue and borrow has been limited under tax reform.

We are prepared to support serious, constructive efforts to help reduce the federal deficit. We are opposed, however, to proposals which simply transfer debt problems to other levels of government which have relied in good faith on existing federal law and commitments.

There are, in fact, many state and local governments which have proceeded in good faith to develop and administer retirement systems which rely in part on the federal Medicare and Social Security systems. But when the federal government terminated the right of states and municipalities to voluntarily withdraw from Social Security and Medicare in 1983, it specifically pre-existing health insurance and retirement systems. We do not understand what has changed since the bipartisan Social Security Commission made its recommendations. therefore, we can't understand the rationale for the administration's proposal.

Finally, on this issue, Mr. Chairman, the administration has attempted to justify this federal tax on the basis of reports that perhaps as many as 75 percent of current municipal employees might be eligible for Medicare benefits without having paid in. We have seen no such data. but we presume there are many non-state and municipal employees who will also be eligible because of their spouse.

If the federal policy is to be that all who might someday be eligible must contribute, then the policy should be structured in a non-discriminatory way to achieve that goal. That goal--and more--has already been achieved for cities under actions already set in the law.

Federal Gas Taxes

The proposal to repeal the exemption from federal excise taxes for state and municipal vehicles would force cities and towns to increase their own taxes in order to maintain current services for essential public services, including police, fire, emergency rescue, and school bus transportation. In the city of Austin alone, this proposal will cost $320,000 per year.

Cities do not have the alternative of cutting back on fuel use consumption or the purchase of trucks or other vehicles and parts: to do so would jeopardize the lives of our constituents.

This is a proposed federal tax increase which will produce one certain result: it will increase the cost of the most important services we provide to the American people.

This proposal strikes us as especially discriminatory. It includes no similar repeal for federal vehicles, nor does it contain any proposal to permit states and local governments to levy "user fees" or local gas taxes on federal vehicles which use our own streets and highways.

Although there has been some attempt to justify this newly proposed federal tax increase as a user fee, we note that the new taxes are not even proposed to come back to us through the federal Highway Trust Fund. Rather they are counted solely for the purpose of deficit reduction.

Of the House Ways and Means Committee Tax Options impacting cities and towns, we are most opposed to those which would directly interfere with our own ability to collect municipal taxes or to borrow for traditional public purposes. We believe that the Tax Reform Act of 1986 made substantial changes in the deductibility of state and local taxes, and we oppose any further changes - especially in the middle of municipal budget years.

Personal Property Tax

We are strongly opposed to any repeal of the personal property tax deduction. An 18.5 percent increase in our personal property tax is a critical effort in the city of Austin's efforts to balance our municipal budget.

A repeal of this deduction would undercut our own efforts - made in good faith reliance on last year's tax bill. For our citizens, it would mean a tax on income never received.

But most importantly such a proposal would unravel the extraordinary effort our community had endured to produce a responsible deficit reduction plan.

Municipal Bonds

We are opposed to proposals to reopen and impose still more restrictions and costs upon our authority and ability to issue debt.

We are especially concerned about proposals to impose still greater restrictions and costs upon our ability, capacity, and authority to issue traditional municipal bonds. We are still awaiting mountains of IRS regulations to tell us how we must comply retroactively with the new law. An overwhelming number of our members believe your committee - if it is going to consider any further changes - should only consider changes to facilitate our ability to provide traditional public purpose financing.

The options menu contains a number of suggestions to increase federal taxes on the interest on traditional municipal bonds. These proposals include:

- o increasing the individual minimum tax from 21 to 26 percent. This would increase the cost to us of issuing bonds for low income housing, airports, and economic development.

- o increasing the alternative corporate (book income) minimum tax. This would increase the cost to us of all municipal borrowing - both for operating essential public services and for financing the construction of schools, jails, and all other traditional public facilities. Coming at a time of reduced federal assistance and increased public infrastructure needs, this proposal would impose severe costs.

- repealing the exemption from the individual minimum tax for general obligation and municipal revenue bonds. This suggestions would, in reality, make all municipal tax exempt bonds taxable. Or, as one of your own staff people put it, it would have a radioactive fallout effect. It would increase the cost of public municipal services and facilities to all American taxpayers. It would begin the process of having the federal government directly tax the bonds and securities of state and local governments.

- reducing the state volume caps on "private activity" municipal bonds by 10 percent, across-the-board cut in individual tax preferences, and a 20 percent cut in other credits (including the low income housing tax credit, the targeted jobs tax credit, and the historic rehabilitation tax credit). This proposal would further restrict the capacity of local government to protect and encourage investment in low income housing, employment training, and physical and economic development. It would make "privatization" even more impossible than the 1984 and 1986 acts have already accomplished.

Other

We are opposed to the option to disallow interest deductions on installment sales of property to municipal governments. This proposal would simply increase the cost of purchasing police cars, computers, and other property and equipment necessary to provide traditional municipal services.

And finally, we oppose any of the options to increase trust fund excise taxes for deficit reduction purposes. Such proposals have discriminatory impacts across different regions.

Moreover, such proposals run counter to the very concept of dedicated trust funds. We believe such funds - and their dedicated taxes - should be removed from the unified budget.

Once again, I am grateful for the opportunity to present our views. We recognize the task you confront; we regard your success as critical to the nation.

Thank you.

Mr. PICKLE. Thank you.
Now we will hear from Mr. Patrick A. Sweeney.
Mr. Sweeney.

STATEMENT OF HON. PATRICK A. SWEENEY, MAJORITY WHIP, OHIO HOUSE OF REPRESENTATIVES, REPRESENTING THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Mr. SWEENEY. Thank you, Mr. Chairman.
My name is Patrick Sweeney, and I'm the majority whip of the Ohio House of Representatives. I also serve on the executive committee of the National Conference of State Legislatures. And I'm here in that capacity, in behalf of the NCSL, to address the issues that sit before this committee.
We are certainly concerned about the proposed Federal revenue measures for deficit reduction and the resultant of that.
Having experienced some of these cuts in the past and having been a casualty of those cuts, we feel rather sensitive about this issue. It was interesting to listen to both the County Commissioners Association and the League of Cities in their dialog before me because they speak almost of the same issues about the limitations and about the thrusts that the whole Federal network puts on them. That is what I am here to talk about.
Essentially the States, when we become a casualty, we pass on, I guess, that pain and have almost uniformly, because we share not only the responsibilities of governance, we also share that limited capacity that we have for taxation.
We in Ohio have been one of those States that looked beyond the reductions in the Federal revenue sharing to our local governments. And this year, just last week, we completed passage of legislation to create a State revenue sharing program. That augments an already large program called the Local Government Fund, that passes money through to our local counties and cities. We feel that that kind of responsibility is exactly what's going on in the States, and it's been historic of our answer and our responsibility toward our jurisdictions—the local governments and dual constituencies that we serve.
The Federal use of excise taxes which seems to be the issue than does the Federal Government. States are generally required to balance their budgets. They do not have, cannot have a monetary policy. And our State taxing options are limited entirely by either the courts or the Federal Government.
The Federal use of excise taxes which seems to be the issues before us hamper State use of those taxes that are historically and traditionally the States. Increasing Federal excise taxes would have a counterproductive effort or result on State and local governments. They would have an absolute reduction of our ability to collect those taxes. There would be a volume impact on our cigarettes, on our alcohol and the like. We have just gone through a court decision—a South Dakota case—that said that the Congress was accurate in insisting that we either raise our drinking age or we lose our highway money. We faced that problem and had to raise our gas tax to accommodate for the needs of our counties and our cities. At the same time, we put in the same package raising the

drinking age, this followed by 18 months a referendum on that same issue that the people of Ohio voted not to reduce or not to raise, but to maintain.

We were working in counterproductive areas. But that impact on loss of liquor taxes, I think, is going to be one of those kinds of things that is soft but continuing, and that is going to result in fewer dollars for local governments. And we feel that the most harmful of the Federal proposals, the excise tax on the motor fuel that would reduce funds available for transportation purposes, to reduce collections on State motor fuel taxes and lower collections for the highway trust fund.

Moreover, it would violate the user fee concept and jeopardize the State-Federal partnership in transportation.

There's much conversation going on about the value added tax. Any sales-tax-based Federal tax would interfere with State fiscal systems. Historically, States and counties, to some degrees, have maintained as its largest source of income that of a sales tax. We think that Federal interference in that and that value added tax conversations that have been going on around the Hill for so many years, would do tremendous violence to our tax structure, both State and locally.

Certain proposals violate that principle of intergovernmental reciprocity. Disallowing or restricting the deductibility of State and local property taxes, increasing the alternative minimum tax, applying Federal motor fuel taxes to State and local governments and the like, all do severe damage.

Congress is urged to avoid revenue measures which encroach on the ability of States and local governments to meet traditional and growing responsibilities. After following the mayor, I think I will take license on behalf of the National Conference of State Legislatures and offer a disclaimer. I too would like to offer some personal opinions on tax options as opposed to those that are structured by our organization.

Like NACO and League of Cities, the voice of the National Conference of State Legislatures has said the Federal Government should utilize and be limited to its traditional taxes, principally the corporate and personal income tax. The realities of that, I think, have made me think that possibly we should reconsider that position. It's unlikely, in my judgment, that this committee, after the brutal war of the last Congress in the Tax Reform Act, is going to face any realistic adjustments of rates upwards or new kinds of levels of income taxes.

In addition to that, to support that position are the recent polls that indicate that the people of America vote 8 to 1 against any increase in income taxes, with the exception of that limited to targeted needs. And 57 percent of the people indicate they will vote for a tax and support a tax that is dedicated to education, that is dedicated to AIDS research and assistance, or dedicated to the homeless. And those are the kinds of things and targeted areas that might be areas of concern.

I, for one, as opposed to the National Conference of State Legislatures' position, would support a tax or a fee on import of oil. I think that would have tremendous long range positive reactions in our economies of States that are oil producing States, it would be

most helpful and would produce the kinds of revenues they think that are necessary to answer your responsibility of budget reduction.

Thank you, Mr. Chairman.

[The statement of Mr. Sweeney follows:]

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President Irving J. Stolberg
Speaker
House of Representatives
Connecticut

Executive Director
Earl S. Mackey

Statement of

REPRESENTATIVE PATRICK A. SWEENEY

HOUSE MAJORITY WHIP

OHIO GENERAL ASSEMBLY

ON BEHALF OF THE

NATIONAL CONFERENCE OF STATE LEGISLATURES

BEFORE THE

COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

July 7, 1987

Denver Office: 1050 17th Street • Suite 2100 • Denver, Colorado 80265 • 303/623-7800

My name is Patrick Sweeney. I am the Majority Whip of the Ohio House of Representatives. I serve on the Executive Committee of the National Conference of State Legislatures. I am here today on behalf of the National Conference of State Legislatures to present our concerns over certain revenue options being weighed as federal deficit reduction measures.

Mr. Chairman, we in the nation's state legislatures understand the urgent need to address the federal budget deficit, and we support your efforts to do so. We know that both the Administration's budget proposal and the Congressional Budget Resolution call for raising additional revenue. In raising the $19.3 billion which the Budget Resolution requires, we urge you to reject any measure that would disrupt intergovernmental fiscal relations and impair the ability of state government to meet its responsiblities to our shared constituencies. Eliminating the deficit is important to all of us, but shifting fiscal problems from one level of government to another is not a valid solution.

Specifically, we are concerned about proposed federal revenue measures that would intrude upon state revenue bases and those that would violate principles of federalism by treating states as commercial enterprises subject to ordinary taxation.

Federal Revenue Measures and State Fiscal Conditions

Throughout this decade, states have been called upon to assume increasing responsibilities in the provision of vital public services to the American people. We have accepted that responsibility, though federal actions have impinged on the ability of states to adequately finance their activities. At the same time, a misconception has arisen among some at the federal level to the effect that the fiscal condition of the states is so strong that states can be expected to shoulder a disproportionate share of the burden of deficit reduction without adversely affecting services.

In reality, the fiscal condition of the states varies widely. During fiscal 1987, 24 states had to cut their budgets in mid-year. (See attached map.) Several states have experienced two or more consecutive years of budget cuts along with tax increases. States in economically distressed regions have encountered concomitant fiscal difficulties. Where the economy is dependent upon energy production, agriculture, and manufacturing problems have been particularly acute. In no region are conditions extremely strong. In FY '86 the 50 states had average budget balances of 2.7 per cent; the benchmark generally accepted as a measure of fiscal soundness is 5 per cent. An NCSL study concluded that,

> The margin of safety separating states from serious fiscal problems is shrinking. If the economy experiences a recession or slows down further, many states will be in fiscal difficulty because their reserve balances are not large. ["State Budget Actions in 1986".]

State Fiscal Constraints

Mr. Chairman, it is important to know that states operate within much more stringent fiscal constraints than does the federal government.

The states impose some of this fiscal discipline on themselves. For example, 49 states have constitutional or statutory requirements that their budget must be balanced. Other constraints are found in the U.S. constitution -- for example, states cannot conduct a monetary policy because they cannot print money. Perhaps most importantly, the federal government restricts the ability of states to raise tax revenue. The U.S. Supreme Court long has interpreted the commerce clause of the Constitution to restrict state taxes that allegedly interfere with interstate commerce. In 1967, for instance, the court forbade states from requiring collection of a sales tax on out-of-state sellers in the *National Bellas Hess* case. (In light of the change of national buying patterns, we are urging Congress to overturn that decision).

Two court decisions this year placed even greater restrictions on state taxes. In a Pennsylvania case, the court struck down a fee on motor carriers.

The court also abrogated a Washington business and occupation tax, and losing it will probably require restructuring the state's tax system.

These, Mr. Chairman, are only the legal constraints on state revenue systems. There are many practical factors that limit states' use of certain taxes. For example, the federal government's heavy reliance on the income tax substantially limits its use by states.

I hope, Mr. Chairman, that the members of this Committee will keep in mind these limitations on revenue sources available at the state and local level when considering various proposals to raise revenue at the federal level.

Excise Taxes -- Encroachment on State Revenue Sources

NCSL is very concerned about proposals to expand the federal government's intrusion into traditional sources of state revenue. Many of the options contained in the handbook prepared for these hearings by the staff of the Joint Committee on Taxation ("Description of Possible Options to Increase Revenues" -- JCS-17-87) do precisely this.

An increase in federal excise taxes would limit state's ability to resort to such taxes when necessary. [II.A.1-2.] Furthermore, states would immediately suffer reduced yields on their own sales taxes on corresponding commodities. NCSL estimates that doubling the cigarette tax, for instance, would cost states $257 million in the first year. Increasing the federal excise rates on beer and wine to the alcohol-equivalent of the tax on distilled spirits would cost states about $140 million. Another $88 million would be lost if the tax on distilled spirits were raised from the current $12.50 to $15.00 per proof gallon. (See attached chart and tables).

Gas Tax Especially Objectionable

Perhaps the most objectionable excise tax proposal is the suggestion that a new excise tax on motor fuels be levied, with the additional revenue being used entirely for deficit reduction, rather than for transportation purposes. [II.A.8.] A 10 cent per gallon increase (which would more than double the present federal tax) would reduce state motor fuel tax collections by $232 million the first year. In subsequent years the revenue drain would increase, so that by the fifth year state collections would be down by almost a billion dollars annually. Over the first five years, states treasuries would lose $3.3 billion. (See attached chart and tables).

The reduction in funds available for the nation's transportation needs would not, however, be limited to the direct loss to the states. Funds from the existing, dedicated tax, which flow into the highway trust fund, would be reduced by $2.6 billion over five years. (See attached chart and tables). In other words, the total loss in funds available for transportation purposes from a 10 cent per gallon, non-dedicated, tax increase would be about $6 billion over five years. This loss would come at a time when many states have undertaken massive new initiatives to rebuild the country's transportation infrastructure. Since the last increase in the federal rate five years ago, 40 states have increased their own gas taxes, 11 this year.

The imposition of such a tax would represent a radical departure from the "user fee" concept which has governed the federal motor fuel tax since the inception of the Interstate Highway Trust Fund; it would be an abrogation of a state-federal partnership in transportation which has served the country well for over thirty years. Mr. Chairman, states were willing to support the increase in the federal rate in 1982 on the understanding that all the revenue would continue to be dedicated to the Trust Fund. Since that time, Congress and the Administration have persistently withheld money in the fund from the states, maintaining a balance in the fund as a "paper offset" to the deficit. A new tax displacing revenue from transportation purposes would further undermine intergovernmental cooperation in this vital area.

Value Added Tax

In recent years there has been much speculation about a national tax on consumption, either a sales tax or a value added tax. There are some who believe that Congress would seriously consider such a levy if annual deficits continue their current pace.

The enactment of such a tax would be wrong for several reasons. First, and most significantly, is the negative impact such a tax would have on state tax bases. States still rely on the sales tax as a major source of revenue, notwithstanding the loss of deductibility in last year's tax legislation. To illustrate, ten years ago the average rate of sales tax among the states was 4 percent; today the average rate is 5 percent. To force a national sales or value added tax would further compromise the fiscal integrity of state governments and complicate the interaction of state and federal tax systems. Such a tax would also create additional compliance problems for community and small businesses and add a substantial layer of bureaucracy to oversee the new system. In sum, VAT is a bad idea and ought to be given a quick dismissal.

Tax Policy and Federalism

Any proposal to limit the deductibility of state and local taxes against federal income taxes violates the principle of intergovernmental reciprocal immunity from taxation, which we see as a fundamental part of federalism. Elimination of the deduction for state sales tax in last year's tax bill was an unfortunate departure from this principle. New proposals to disallow the deduction for personal property taxes, impose a floor under itemized deductions, or to limit tax-liability reduction represent a further potential encroachment on the fiscal integrity of state and local government. Furthermore, since states vary greatly in their use of personal property taxes, such a measure would have very disproportionate effects among states. [II.D.3.c.]

Changes in tax-exempt financing that were part of the Tax Reform Act of 1986 had a direct impact on state and local governments. Placing volume caps on the issuance of bonds, requiring the rebate of arbitrage earnings and reclassifying types of public purpose bonds all had an effect on the ability of states to fund public activities.

Among the provisions of tax reform that raised constitutional, as well as financial, questions was the imposition of the alternative minimum tax on certain private activity bonds. [II.D.15] The constitutional questions will be addressed in court. However, Congress need not wait for a Court decision to reflect on the damage to intergovernmental relations caused by an unwise policy. The alternative minimum tax raises the cost of issuance for state and local governments, and hampers flexibility in forming partnerhsips that help fulfill public purposes. Taxing the interest from supposedly tax-exempt bonds undercuts a principle of reciprocal tax immunity that contributes to the fiscal integrity of the states.

To revisit a part of tax reform that raises serious constitutional and policy questions and then to make its provisions more burdensome for state and local governments is not the proper course to take to reduce the deficit.

Another measure that threatens state and local government is the proposal that excise taxes be increased to offset the "revenue loss" from outstanding tax-exempt bonds. [II.A.10.2.] Mr. Chairman, the financial instruments of state and local governments are either tax-exempt, or they are not. The attempt to place any kind of tax on them not only imposes further fiscal difficulties on state government; it indicates a degree of disrespect for the role of states as independent sovereigns within our federal system. The same must be said of the proposal, put forward by the Administration, to require state and local governments to pay federal motor fuel taxes. [I.B.2.]

Finally, the proposed mandatory extension of Medicare coverage to all employees of state and local governments poses a serious violation of the 1985 agreement to phase-in Medicare coverage to all newly hired employees after May 31, 1986, reached by the Administration, Congress and the States in the Consolidated Omnibus Budget Reconciliation Act of 1985. This proposal would put an immediate, additional expense on state budgets of $1.5 billion. For the 4 to 5 million low-to-moderate income employees of state and local governments, the mandatory extension of coverage would effectively eliminate the tax relief promised in the Tax Reform Act of 1986. Such a proposal does not take into consideration the fiscal conditions of the states or their employees, nor the need for gradual change to accomodate state and individual economic constraints. [I.A.1]

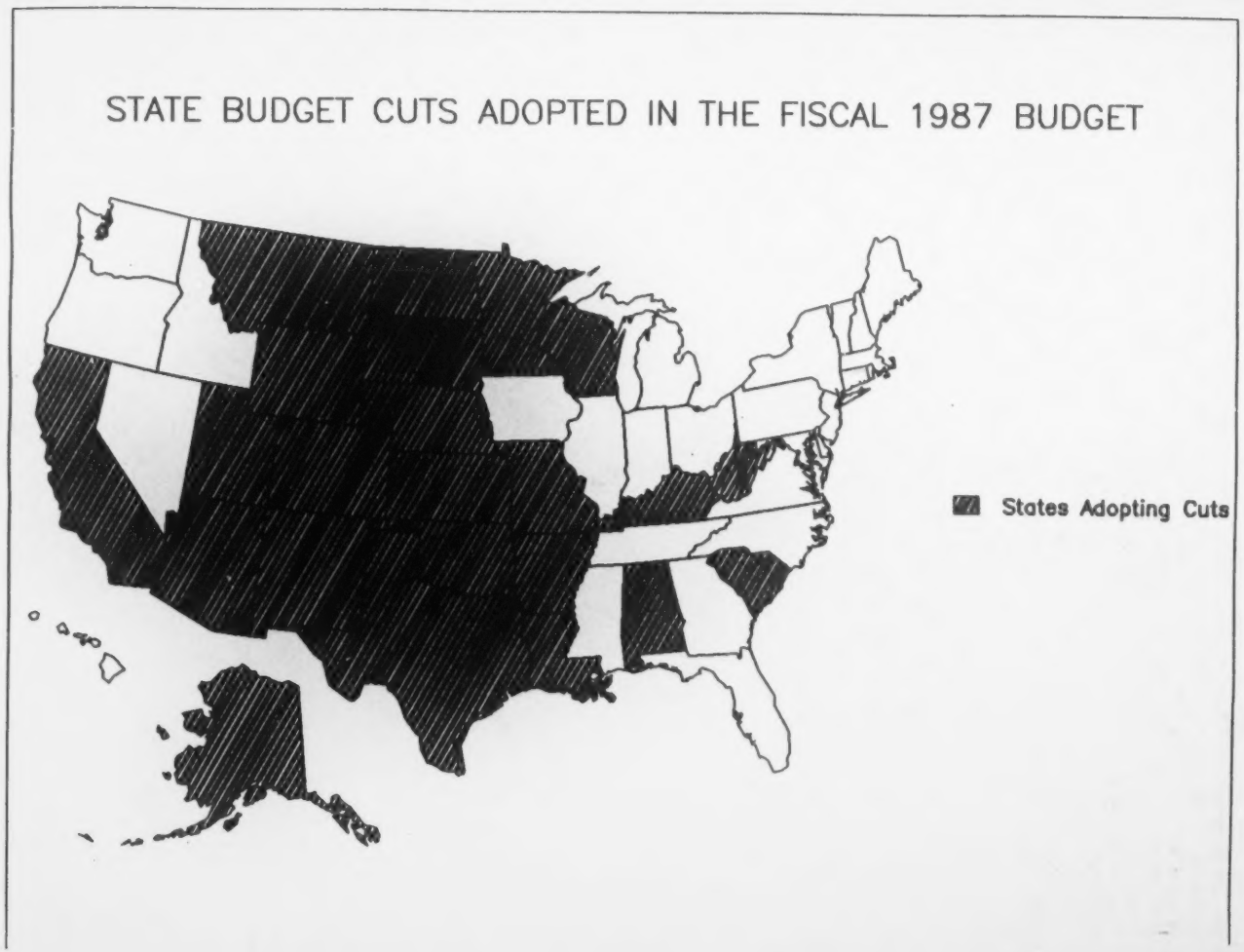
Conclusion

Mr. Chairman, we in state government stand ready to bear our share of the burden in the effort to reduce the deficit. Over the past several years state

and local government has in fact, taken a disproportionate share of federal cutbacks. The National Conference of State Legislatures has made constructive proposals addressing the deficit dilemma, on both the spending side and on the revenue side. We have repeatedly signalled our willingness to have the entire budget, save means-tested entitlements, subjected to scrutiny. Our belief is that this approach is necessary to ensure that the burden of budget cuts will be spread equitably.

Similarly, if revenue must be raised, we believe that all revenue options that respect the principle of intergovernmental reciprocal immunity from taxation should be open for Congressional consideration. As we have stated in the past, we believe that the federal government should continue to rely on corporate and individual income taxes for its principal source of revenue.

Bearing in mind the precarious fiscal condition of many states, and the constrained fiscal environment in which states must operate, we ask you not to enact measures which encroach upon the ability of state and local government to meet traditional and growing responsibilities.


STATE BUDGET CUTS ADOPTED IN THE FISCAL 1987 BUDGET
States Adopting Cuts

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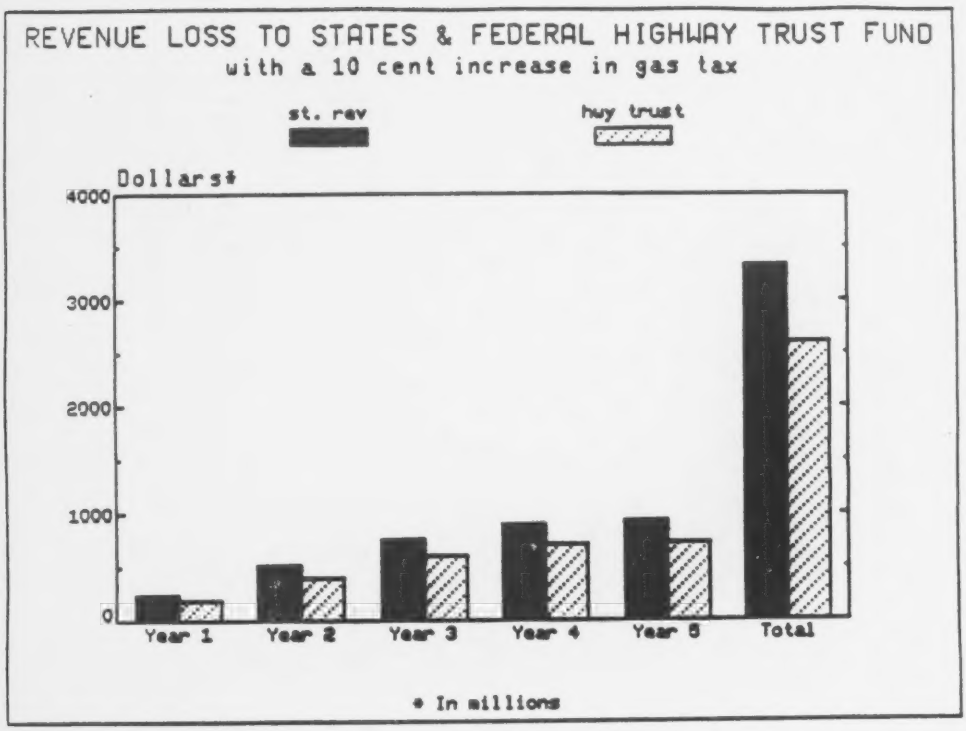

STATE REVENUE LOSS RESULTING FROM A 10 CENT INCREASE IN THE FEDERAL GAS TAX
(In thousands of dollars)

STATE	1988	1989	1990	1991	1992	TOTAL
AL	3760.58	8273.29	12284.57	14540.93	15042.34	53901.71
AK	343.10	754.82	1120.79	1326.65	1372.40	4917.77
AZ	4366.54	9606.38	14264.03	16883.95	17466.15	62587.05
AR	2708.52	5958.74	8847.83	10472.94	10834.08	38822.12
CA	17335.53	38138.16	56629.39	67030.71	69342.11	248475.90
CO	4623.67	6736.67	10002.93	11840.21	12248.49	45451.97
CT	4431.22	9748.69	15922.86	19704.17	20383.62	70190.56
DE	723.33	1591.33	2362.89	2796.89	2893.33	10367.77
DC	369.38	812.64	1206.65	1428.28	1477.53	5294.48
FL	8672.09	19078.61	28328.84	33532.10	34688.38	124300.01
GA	4286.59	9430.49	14002.85	16574.81	17146.35	61441.09
HI	881.63	1939.58	2879.98	3408.95	3526.50	12636.64
ID	1207.66	2656.86	3945.03	4669.63	4830.65	17309.83
IL	10470.45	23034.98	34203.45	40485.72	41881.78	150076.38
IN	6797.40	14954.28	22204.84	26283.28	27189.60	97429.41
IA	3932.31	8651.08	12845.55	15204.93	15729.24	56363.11
KS	2469.99	5433.98	8068.64	9550.63	9879.96	35403.20
KY	4429.82	9745.59	14470.73	17128.62	17719.26	63494.02
LA	5266.28	11585.81	17203.18	20362.95	21065.12	75483.34
ME	1356.85	2985.08	4432.39	5246.50	5427.42	19448.24
MD	6174.54	13583.98	20170.15	23874.87	24698.14	88501.68
MA	4285.14	9427.31	13998.13	16569.22	17140.57	61420.37
MI	9796.35	21551.96	32001.40	37879.21	39185.39	140414.31
MN	5704.97	12550.94	18636.25	22059.24	22819.90	81771.30
MS	3734.64	8216.22	12199.83	14440.62	14938.57	53529.89
MO	4945.70	10880.54	16155.96	19123.38	19782.81	70888.39
MT	1545.49	3400.08	5048.60	5975.89	6181.96	22152.01
NE	2639.75	5807.46	8623.19	10207.04	10559.01	37836.45
NV	1017.49	2238.48	3323.80	3934.30	4069.96	14584.04
NH	996.72	2192.78	3255.94	3853.97	3986.87	14286.27
NJ	4617.35	10158.18	15083.36	17853.77	18469.42	66182.08
NM	1878.12	4131.86	6135.19	7262.07	7512.48	26919.72
NY	7610.88	16743.94	24862.22	29428.75	30443.54	109089.34
NC	8083.34	17783.34	26405.57	31255.57	32333.35	115861.16
ND	1094.77	2408.50	3576.25	4233.11	4379.08	15691.72
OH	9727.14	21399.70	31775.31	37611.60	38908.55	139422.30
OK	4909.37	10800.62	16037.28	18982.91	19637.49	70367.67
OR	2292.41	5043.29	7488.53	8863.97	9169.62	32857.82
PA	9092.32	20003.10	29701.58	35156.97	36369.28	130323.26
RI	785.68	1728.51	2566.57	3037.98	3142.74	11261.47
SC	3746.90	8243.18	12239.87	14488.01	14987.60	53705.56
SD	892.07	1962.56	2914.10	3449.35	3568.29	12786.37
TN	7488.53	16474.76	24462.53	28955.65	29954.12	107335.58
TX	15696.42	34532.12	51274.97	60692.82	62785.67	224982.00
UT	2303.83	5068.44	7525.86	8908.16	9215.34	33021.63
VT	565.56	1244.23	1847.50	2186.83	2262.24	8106.37
VA	8207.36	18056.18	26810.70	31735.11	32829.43	117638.78
WA	5805.58	12772.28	18964.90	22448.24	23222.32	83213.32
WV	1442.02	3172.44	4710.59	5575.80	5768.07	20668.93
WI	6233.90	13714.57	20364.06	24104.39	24935.58	89352.50
WY	517.57	1138.65	1690.73	2001.27	2070.28	7418.50
TOTAL:	232264.86	507547.28	755078.35	894622.91	925471.98	3314985.37

Sources: Federal Highway Administration; Joint Committee on Taxation, U.S. Congress; American Automobile Association.

Table II

HIGHWAY TRUST FUND LOSS RESULTING FROM A 10 CENT INCREASE IN THE FED. GAS TAX
(In thousands of dollars)

STATE	1988	1989	1990	1991	1992	TOTAL
AL	3360.77	7393.69	10978.51	12994.97	13443.08	48171.03
AK	450.44	990.96	1471.43	1741.69	1801.75	6456.28
AZ	2701.89	5944.16	8826.17	10447.31	10807.56	38727.08
AR	2102.18	4624.81	6867.14	8128.45	8408.74	30131.32
CA	18537.88	40783.33	60557.07	71679.80	74151.51	265709.59
CO	2456.64	5404.61	8025.02	9499.00	9826.55	35211.82
CT	2157.56	4746.64	7048.04	8342.58	8630.25	30925.07
DE	547.17	1203.78	1787.43	2115.73	2188.68	7842.79
DC	219.06	481.93	715.59	847.02	876.23	3139.82
FL	8639.15	19006.14	28221.24	33404.73	34556.62	123827.89
GA	5753.33	12657.33	18794.22	22246.22	23013.33	82464.45
HI	463.34	1019.34	1513.56	1791.57	1853.34	6641.15
ID	838.72	1845.18	2739.81	3243.04	3354.87	12021.62
IL	7612.76	16748.06	24868.33	29435.99	30451.02	109116.16
IN	4947.92	10885.43	16163.22	19131.97	19791.70	70920.25
IA	2422.27	5328.99	7912.74	9366.10	9689.07	34719.15
KS	2196.19	4831.63	7174.23	8491.95	8784.77	31478.77
KY	3044.22	6697.29	9944.47	11771.00	12176.90	43633.88
LA	3261.78	7175.92	10655.15	12612.21	13047.12	46752.17
ME	978.72	2153.18	3197.14	3784.37	3914.87	14028.28
MD	3250.16	7150.36	10617.20	12567.30	13000.65	46585.68
MA	3725.04	8195.08	12168.45	14403.47	14900.14	53392.17
MI	6294.39	13847.65	20561.67	24338.30	25177.55	90219.56
MN	3285.75	7228.64	10733.44	12704.89	13142.99	47095.71
MS	2228.88	4903.54	7281.02	8618.35	8915.53	31947.31
MO	4457.99	9807.57	14562.76	17237.56	17831.95	63897.83
MT	793.61	1745.94	2592.46	3068.62	3174.44	11375.06
NE	1436.39	3160.06	4692.21	5554.04	5745.56	20588.25
NV	878.01	1931.63	2868.17	3394.98	3512.05	12584.85
NH	679.54	1494.98	2219.82	2627.54	2718.15	9740.04
NJ	5371.02	11816.24	17545.33	20767.95	21484.08	76984.63
NM	1335.61	2938.34	4362.98	5164.35	5342.43	19143.71
NY	8880.84	19537.84	29010.74	34339.24	35523.35	127292.01
NC	5164.27	11361.39	16869.94	19968.50	20657.07	74021.18
ND	666.47	1466.23	2177.13	2577.02	2665.88	9552.73
OH	8045.59	17700.30	26282.27	31109.63	32182.37	115320.16
OK	3199.94	7039.87	10453.13	12373.10	12799.76	45865.79
OR	1751.06	3852.34	5720.14	6770.78	7004.26	25098.59
PA	7526.20	16557.64	24585.58	29101.30	30104.80	107875.52
RI	571.54	1257.38	1867.02	2209.94	2286.15	8192.04
SC	2863.15	6298.93	9352.96	11070.85	11452.60	41038.49
SD	706.15	1553.53	2306.76	2730.45	2824.61	10121.51
TN	4430.22	9746.49	14472.07	17130.20	17720.90	63499.89
TX	15581.23	34278.70	50898.68	60247.42	62324.92	223330.95
UT	1212.88	2668.33	3962.06	4689.79	4851.50	17384.55
VT	420.56	925.24	1373.84	1626.18	1682.26	6028.09
VA	4712.99	10368.57	15395.75	18223.54	18851.94	67552.79
WA	3147.22	6923.88	10280.91	12169.25	12588.87	45110.13
WV	1346.40	2962.08	4398.24	5206.09	5385.61	19298.42
WI	3438.15	7563.93	11231.29	13294.17	13752.59	49280.13
WY	688.40	1514.49	2248.79	2661.83	2753.62	9867.13
TOTAL:	180781.64	397719.60	590553.35	699022.33	723126.55	2591203.47

Sources: Federal Highway Administration; Joint Committee on Taxation, U.S. Congress; American Automobile Association.

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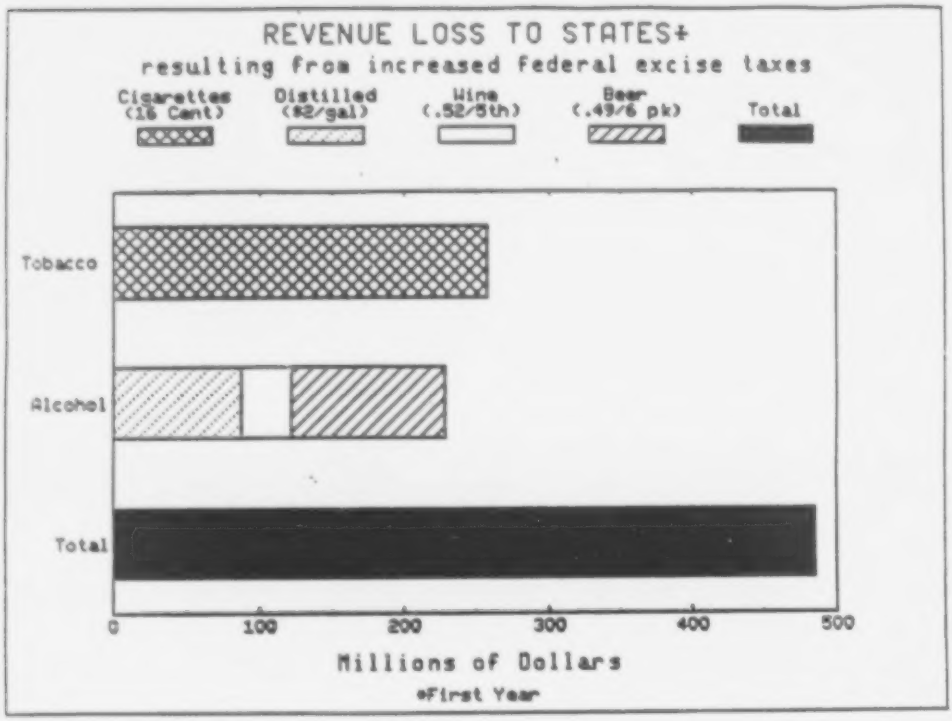

National Conference of State Legislatures

STATE REVENUE LOSS RESULTING FROM INCREASED FEDERAL EXCISE TAX ON CIGARETTES
(In Thousands of Dollars)

STATE	COLLECTIONS*	FIRST YEAR		OVER FIVE YEARS	
		LOST ST REV .08 TAX INCR	LOST ST REV .16 TAX INCR	LOST ST REV .08 TAX INCR	LOST ST REV .16 TAX INCR
AL	71,199.00	2071.244	4142.487	10356.218	20712.436
AK	8,109.00	235.898	471.796	1179.491	2358.982
AZ	50,005.00	1454.691	2909.382	7273.455	14546.909
AR	59,788.00	1739.287	3478.575	8696.436	17392.873
CA	258,975.00	7533.818	15067.636	37669.091	75338.182
CO	50,929.00	1481.571	2963.142	7407.855	14815.709
CT	88,588.00	2577.105	5154.211	12885.527	25771.055
DE	12,300.00	357.818	715.636	1789.091	3578.182
DC	9,299.00	270.516	541.033	1352.582	2705.164
FL	289,692.00	8427.404	16854.807	42137.018	84274.036
GA	88,580.00	2576.873	5153.745	12884.364	25768.727
HI	17,704.00	515.025	1030.051	2575.127	5150.255
ID	8,412.00	244.713	489.425	1223.564	2447.127
IL	198,964.00	5788.044	11576.087	28940.218	57880.436
IN	76,365.00	2221.527	4443.055	11107.636	22215.273
IA	70,540.00	2052.073	4104.145	10260.364	20520.727
KS	56,514.00	1644.044	3288.087	8220.218	16440.436
KY	18,287.00	531.985	1063.971	2659.927	5319.855
LA	81,696.00	2376.611	4753.222	11883.055	23766.109
ME	37,719.00	1097.280	2194.560	5486.400	10972.800
MD	67,603.00	1966.633	3933.265	9833.164	19666.327
MA	173,263.00	5040.378	10080.756	25201.891	50403.782
MI	239,387.00	6963.985	13927.971	34819.927	69639.855
MN	97,635.00	2840.291	5680.582	14201.455	28402.909
MS	49,540.00	1441.164	2882.327	7205.818	14411.636
MO	81,783.00	2379.142	4758.284	11895.709	23791.418
MT	12,514.00	364.044	728.087	1820.218	3640.436
NE	30,872.00	898.095	1796.189	4490.473	8980.945
NV	19,488.00	566.924	1133.847	2834.618	5669.236
NH	32,859.00	955.898	1911.796	4779.491	9558.982
NJ	215,905.00	6280.873	12561.745	31404.364	62808.727
NM	14,804.00	430.662	861.324	2153.309	4306.618
NY	424,096.00	12337.338	24674.676	61686.691	123373.382
NC	16,515.00	480.436	960.873	2402.182	4804.364
ND	11,694.00	340.189	680.378	1700.945	3401.891
OH	183,849.00	5348.335	10696.669	26741.673	53483.345
OK	68,183.00	1983.505	3967.011	9917.527	19835.055
OR	74,346.00	2162.793	4325.585	10813.964	21627.927
PA	238,100.00	6926.545	13853.091	34632.727	69265.455
RI	30,517.00	887.767	1775.535	4438.836	8877.673
SC	28,073.00	816.669	1633.338	4083.345	8166.691
SD	14,738.00	428.742	857.484	2143.709	4287.418
TN	77,972.00	2268.276	4536.553	11341.382	22682.764
TX	358,783.00	10437.324	20874.647	52186.618	104373.236
UT	12,403.00	360.815	721.629	1804.073	3608.145
VT	11,610.00	337.745	675.491	1688.727	3377.455
VA	17,238.00	501.469	1002.938	2507.345	5014.691
WA	103,011.00	2996.684	5993.367	14983.418	29966.836
WV	35,422.00	1030.458	2060.916	5152.291	10304.582
WI	121,428.00	3532.451	7064.902	17662.255	35324.509
WY	4,766.00	138.647	277.295	693.236	1386.473
TOTAL:	4,422,062.00	128,641.80	257,283.61	643209.018	1286418.036

*COLLECTIONS represents net cigarette tax collections for period ending June 30, 1986

National Conference of State Legislatures

STATE REVENUE LOSS RESULTING FROM INCREASED FEDERAL EXCISE TAX ON ALCOHOLIC BEVERAGES

(In Thousands of Dollars)

STATE	DISTILLED ($2.00/gal.)	WINE ($.52/5th)	BEER ($.49/6 pk)	TOTAL
AL	2243.184	435.700	2095.350	4774.234
AK	246.344	81.000	234.181	561.525
AZ	1065.680	740.300	2031.078	3837.058
AR	493.679	110.400	818.479	1422.558
CA	6208.196	3708.350	7321.858	17238.404
CO	858.992	427.350	1124.842	2411.185
CT	1624.772	871.450	1659.165	4155.388
DE	117.018	32.350	45.979	195.347
DC	611.958	339.700	491.063	1442.721
FL	6716.465	4253.350	11161.739	22131.554
GA	1716.574	932.300	3453.796	6102.670
HI	162.168	113.750	457.114	733.032
ID	313.349	307.350	405.326	1026.024
IL	3031.360	1331.900	4615.512	8978.772
IN	1266.814	464.200	2327.965	4058.979
IA	1401.394	530.650	1151.128	3083.172
KS	600.490	178.250	1020.400	1799.140
KY	703.188	205.250	1238.760	2147.199
LA	1182.398	374.450	2863.070	4419.918
ME	748.729	179.500	683.879	1612.108
MD	1060.727	495.050	1481.634	3037.411
MA	2061.143	745.350	1195.212	4001.705
MI	4140.418	968.200	3807.828	8916.446
MN	2305.656	667.100	2743.673	5716.429
MS	1210.466	252.300	1751.906	3214.673
MO	909.666	393.450	1689.694	2992.810
MT	406.801	127.550	143.335	677.686
NE	300.800	120.650	563.904	985.355
NV	474.976	227.650	433.795	1136.421
NH	754.072	282.750	465.272	1502.094
NJ	2336.877	1107.950	1791.953	5236.780
NM	339.046	201.700	749.922	1290.668
NY	7133.262	1794.250	4096.228	13023.740
NC	2698.108	995.950	3442.960	7137.018
ND	194.349	47.550	309.824	551.723
OH	4143.991	1035.800	5535.261	10715.052
OK	744.766	179.000	1094.396	2018.162
OR	1652.031	319.950	241.597	2213.577
PA	5068.217	2391.050	3089.464	10548.731
RI	332.562	194.350	457.155	984.067
SC	1760.493	448.000	3080.153	5288.646
SD	234.186	67.400	319.176	620.762
TN	1686.764	580.900	1561.974	3829.638
TX	4020.128	1750.600	12099.080	17869.809
UT	737.501	314.350	649.436	1701.287
VT	348.832	80.550	233.480	662.863
VA	2753.915	1087.100	2468.416	6309.430
WA	4273.407	1466.700	1739.093	7479.200
WV	587.101	103.750	797.756	1488.607
WI	1612.254	390.600	2046.981	4049.835
WY	196.751	70.250	173.081	440.082
TOTAL:	87792.019	34525.350	105454.325	227771.694

Mr. PICKLE. Thank you, Mr. Sweeney. You ended your testimony on a very fine favorable note. And I thank you.

Now, Mr. Stifter, if you will proceed.

STATEMENT OF RICHARD M. STIFTER, ASSISTANT DIRECTOR OF UNEMPLOYMENT AND WORKERS' COMPENSATION, GENERAL MOTORS CORP., REPRESENTING EMPLOYEE BENEFITS AND RELATIONS COMMITTEE, COUNCIL OF STATE CHAMBERS OF COMMERCE, ACCOMPANIED BY WILLIAM R. BROWN, PRESIDENT, COUNCIL OF STATE CHAMBERS OF COMMERCE

Mr. STIFTER. Thank you, Mr. Chairman. It's a pleasure to be here.

My name is Richard M. Stifter. I'm assistant director of unemployment and workers' compensation for General Motors Corp. Accompanying me today is Mr. William R. Brown, who is president of the Council of State Chambers of Commerce. And I appear here on behalf of that organization.

My testimony is going to be rather limited in that we appear here today in opposition to the two Federal unemployment tax proposals on pages 76 through 78. One would index the taxable wage base, and the second would extend the temporary two-tenths FUTA tax which the Secretary of Labor has announced will end January 1, 1988, because the debt which it was enacted to repay is in fact repaid.

I appeared before this committee on July 22, 1986, on the issue of the continuance of the two-tenths temporary FUTA tax, and my reasons for opposing it now are essentially the same.

I would just point out that the latest estimates of the U.S. Department of Labor indicate that the extended unemployment account will have a balance of $1.24 billion by the end of fiscal year 1987 and, in fact, in 1988 will exceed its statutory limit without the additional two-tenths.

In addition, the U.S. Department of Labor projects that there will be $1.51 billion in the administrative account at the end of fiscal year 1987, and the administration is currently analyzing equitable ways to return that financing, the administrative financing to the States.

The proposal to index the Federal taxable wage base would make a very fundamental change in the Federal/State unemployment insurance program. It would not be appropriate to make such a basic change as part of this process which will not allow time for proper analysis of its ramifications.

Let me just point out that there are currently 36 States that have wage bases higher than the FUTA tax. Among these, Illinois is scheduled to reduce to 7,000 in 1988, and then another, Connecticut, that the wage base is $7,100. Consequently, if the FUTA base is increased, 19 States, including Puerto Rico, will be forced to increase their taxable wage base for State UCA taxes.

The taxable wage base would also have a very disturbing impact on the experience rating. Experience rating has been basic to the U.S. unemployment system, and ever since every State has a different formula, it would require additional analysis on a State-by-State basis.

In summary, I submit that there is no need in the unemployment system to increase taxes. These are dedicated taxes and can only be used for the State unemployment system.

I thank you.

[The statement of Mr. Stifter follows:]

STATEMENT BY RICHARD M. STIFTER
TO THE HOUSE WAYS & MEANS COMMITTEE
IN BEHALF OF THE EMPLOYEE BENEFITS & RELATIONS COMMITTEE
OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE
July 7, 1987

I am Richard M. Stifter. I am Assistant Director of Unemployment and Workers Compensation for General Motors. Accompanying me is William R. Brown, President of the Council of State Chambers of Commerce.

We appear here today to oppose the two Federal Unemployment Tax proposals on pages 76-78 of the Revenue Options booklet to: (1) index the FUTA wage base and, (2) extend the "temporary" .2% FUTA tax which the Secretary of Labor has announced will end January 1, 1988 because the debt which it was enacted to repay is repaid.

Strangely the Option Booklet groups these proposals under "Excise Taxes". However, FUTA is not an "excise" tax - it is a payroll tax. Payroll taxes are regressive. As is recognized in the option booklet, they discourage employment. If there was any need to use these taxes for the purposes for which they are earmarked, then a case might be made for taxing payroll. But, this is not the situation. Certainly Congress should be able to find a better way than taxing jobs and job creation! Relying on payroll taxes to help balance the budget is not a good way to improve our international competitive situation either.

INDEXING FUTA WAGE BASE NOT APPROPRIATE

The proposal to index the Federal Unemployment Tax wage base would make a very fundamental change in the Federal-State Unemployment Insurance program. It would not be appropriate to make such a basic change as part of this process which will not allow time for proper analysis of its ramifications. Nor, will it produce a significant amount of revenue to help reduce the deficit - in fact the immediate result is zero because, as the Option Booklet explains, it would not be effective until years after 1988 in order to allow States time to conform their laws since the States are permitted to use a tax base no lower than the Federal.

Unlike Social Security, indexing FUTA is of no direct benefit to the persons drawing the benefits. Unemployment benefits are based on wage records, as defined by State laws, that are unrelated to the Federal or State taxable wage base.

REVENUE NOT NEEDED FOR EMPLOYMENT SECURITY

I appeared before this Committee on July 22, 1986 on the issue of the continuation of the 0.2% temporary FUTA tax and my reasons for opposing it now are essentially the same.

I wish to make it unquestionably clear that there is no need for either the .2% extension or indexing:

(1) Latest estimates of the U.S. Department of Labor indicate the Extended Unemployment Compensation Account (E.U.C.A). account will have a balance of $1.24 billion by the end of Fiscal Year 1987, October 1, 1987; (and that it will exceed its ceiling of $2.17 billion in Fiscal Year 1988 without the .2% tax).

(2) The outlays from E.U.C.A. for 1986 for extended benefit payments totalled only $50 million.

(3) The outlays from E.U.C.A. from 1987 for extended benefits is estimated at $70 million (and only $10 million in 1988).

(4) The projected interest earnings on the E.U.C.A. fund are $50 million in 1987 -- $150 million in 1988; more than enough to meet projected outlays for those two years.

(5) The income that will go into the E.U.C.A. fund from employer F.U.T.A. taxes, less the .2% surcharge, are estimated at $840 million in 1988.

Now Let us look at the indexing of the taxable wage base. The first question is why?

The Administration is analyzing equitable ways to return administration funding to the States. The US Dept. of Labor projects that there will be $1.51 billion in the Administration Account at the end of the fiscal year 1987. Why increase this Federal dedicated tax at a time when the Administration and the Department of Labor is attempting to eliminate it.

Details of the indexing mechanism are not revealed in the Joint Committee's document, but the Congressional Budget Office tells us it would operated like the index for Social Security, There would be a two year lag, i.e. the percentage change in average wages between 1986 and 1987 would determine the taxable wage base increase for calendar year 1989, estimated at a 4.2% increase producing a $7,300 base in 1989. A 5.2% increase is predicted between 1987 and 1988 producing a $7,700 base in 1990. The revenue effect of the proposal would be an additional $200 million in fiscal year 1989 and $600 million in fiscal year 1990, an more and more each succeeding year.

Changes in the F.U.T.A. Wage Base Requires Changes in the Taxable Wage Base of the States

States that choose to set their taxable wage base for state U.C. taxes above the $7,000 F.U.T.A. base are free to do so -- but no state is allowed to have a wage base for state U.C. taxes below the F.U.T.A. base without incurring a severe penalty tax. Currently 36 states have wages bases higher than the F.U.T.A. base. One of those states, Illinois, is scheduled under current state law, to return to $7,000 in 1988; and, another, Connecticut has a wage base of $7,100. Consequently, if the F.U.T.A. base is indexed, 19 states (including Puerto Rico) will be forced to increase their wage base for state U.C. taxes.

Most of those states have a positive reserve fund. Many of them have increased tax rates in the last two of three years and therefore neither need, nor want, a higher taxable wage base.

Even more diabolical is the fact that continually increasing the F.U.T.A. wage base would require the states to continually increase their state taxable wage bases to keep pace -- regardless of the need for additional revenues.

Indexing the F.U.T.A. Wage Base Would Disrupt Experience Rating for Many States

A formula for allocating tax rates on the basis of an employer's experience with unemployment is contained in every state law, except in Puerto Rico. Experience rating is a concept embraced by the U.C. system throughout its history. It is the only way states can equitably apportion the cost of benefit payments.

The formulae vary from state to state, but in many states the amount of wages subject to taxation is used as an indicator of the benefit risk exposure. Thus, when an employer employees additional people, his wages subject to tax go up; if he lays off people, the wages go down. This, in turn, is likely to have an impact upon his experience rating. But, if the federal government, by increasing the F.U.T.A. wage base, forces an increase in the state wage base, all employers in the state experience an increase in the amount of wages subject to tax -- even if they have no increase in employment.

Over the history of the U.C. system, Congress has been sensitive to that fact and has increased the F.U.T.A. wage base rarely (only three times in the 52 year history of the program). Trying to continually change state tax rate schedules to accommodate to a changing tax base would be very difficult.

There Is No Valid Comparison of F.U.T.A. Taxes and Social Security Taxes

Trying to compare F.U.T.A. taxes with Social Security Taxes (which are indexed) is comparing apples and oranges. Social Security taxes are levied principally to pay benefit costs. F.U.T.A. is not. Actuaries can predict with a reasonable degree of accuracy what future Social Security costs will be. That's not the case with demands on F.U.T.A. costs, which depend upon the economic environment. Social Security has little or no relationship to the activities taking place under state legislated programs. F.U.T.A. demands are programs and their activities.

There may be justifiable reasons for indexing the wage base for the Federal Social Security Program. There are none for indexing the F.U.T.A. tax.

CONCLUSION

In summary I submit that there is no need in the unemployment system to increase taxes. These are dedicated taxes and can only be used in the unemployment system. To represent these taxes as a reduction in the National debt is erroneous at best.

Mr. PICKLE. Thank you, sir.
Ms. Dix, if you'll proceed.

STATEMENT OF PATRICIA DIX, LEGISLATIVE SPECIALIST, NATIONAL EDUCATION ASSOCIATION

Ms. DIX. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am Pat Dix, a legislative specialist for the National Education Association.

The 1.8 million member National Education Association representing public educational employees throughout the country, urges this committee to reject any proposal to force Medicare coverage on public employees who are not currently covered.

In addition, we oppose the extension of mandatory Social Security coverage on uncovered public employees.

After full consideration of proposals to impose mandatory Medicare on all State and local employees simultaneously, Congress agreed to phase in Medicare coverage for all employees hired after April 1, 1986, under COBRA, the Consolidated Omnibus Budget Reconciliation Act of 1985.

To now extend coverage to all public employees would be a breach of faith with State and local governments. Mandatory coverage of school employees under Medicare would impose an immediate and severe financial burden on school districts and other State and local agencies. The cost of coverage for State and local governments is estimated to be $800 million in the first year, and $1 billion thereafter, with an equal amount paid by employees.

Schools and other State and local agencies do not have the resources to absorb the added cost of Medicare coverage for noncovered employees. Some 23 States were forced to cut fiscal year 1987 budgets and 19 States are projected to cut fiscal year 1988 budgets below fiscal year 1987 funding.

The alternative to cutting services is raising taxes. In fiscal year 1986 alone, nine States increased the sales tax, eight States increased the gasoline excise tax, and three States increased the personal income tax.

In fiscal year 1987, 20 States have already raised taxes, and 8 more are considering tax increases. In most cases, just to maintain existing services.

In short, mandating Medicare coverage for uncovered employees could, in concert with constitutional or statutory limits on revenue, annual budget reductions, and severe economic setbacks, result in the elimination of entire educational programs and staff layoffs in many States and communities.

At the same time, this proposal would harm individual public employees. The salaries of education employees would be adversely affected in two ways. First, the average increase in payroll taxes for these lower and middle income employees is estimated to be almost twice the average decrease in general income taxes under the Tax Reform Act of 1986. Second, because of the large sums State and local agencies would need to pay this additional payroll tax, school districts and other government entities would not have funds to provide compensation increases, either for cost-of-living in-

creases or to enhance incentives to attract and retain qualified school employees.

Given education reform efforts intended to upgrade standards or responsibilities for education employees, individuals would be asked to do more for less at the same time they are being asked to do more with less.

When Congress created the Social Security and Medicare system, our members and other public employees were excluded from coverage. These affected employees worked at the state and local level to establish retirement systems that would afford health care coverage that would be adequate and predictable into their futures. Mandatory Medicare coverage would not result in improved benefits for many of these public employees.

We recognize that Congress faces a range of difficult choices in its efforts to reduce the tremendous projected Federal deficit and enormous Federal debt, but the answer is not to shift such a severe burden to a limited segment of the population. Vital public services—including education, police and fire protection, and other services important to the health and safety of whole communities—would suffer disproportionately from a proposal that would have only a negligible, short-term impact on the Federal deficit.

Current law will, in a short time, bring all public employees under the Medicare system. The turnover rate for State and local employees is about 9 percent a year. This gradual phase-in will allow public employers to adapt to the change with careful budget planning, rather than throwing a monkey wrench into the operation of the affected States and communities.

We urge the committee to reject any proposal that would mandate Medicare or Social Security coverage for current State and local employees. Thank you.

[The statement of Ms. Dix follows:]

STATEMENT OF PAT DIX, LEGISLATIVE SPECIALIST
NATIONAL EDUCATION ASSOCIATION

Mr. Chairman and Members of the Committee:

I am Pat Dix, a legislative specialist for the National Education Association. The 1.8 million-member National Education Association, representing public education employees throughout the country, urges this Committee to reject any proposal to force Medicare coverage on public employees who are not presently covered. In addition, we oppose the extension of mandatory Social Security coverage on uncovered public employees.

Mandatory coverage of school employees under Medicare would put a tremendous financial burden on school districts and would reduce the take-home pay of school employees. Given that Congress has already taken action to phase in all state and local employees, it would be a breach of faith with state and local governments and with public employees to now mandate coverage of current state and local employees.

When Congress created the Social Security/Medicare system, our members and other public employees were excluded from coverage. It was more than 20 years after enactment of the Social Security/Medicare system before public employees could elect to participate in the system.

Public employees excluded from Medicare and Social Security coverage worked -- at great expense to employers and employees -- to establish retirement systems that afford health care coverage. Extensive state law has developed to assure that the benefits of these retirement systems will be adequate and predictable far into the future.

Impact on State and Local Governments

After full consideration of proposals to impose mandatory Medicare on state and local employees all at once, Congress agreed to phase in Medicare coverage for all employees hired after April 1, 1986 through the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). To now extend coverage to all public employees would be a breach of faith with state and local governments.

Mandatory coverage of school employees under Medicare would impose an immediate and severe financial burden on school districts and other state and local agencies. The cost of coverage for state and local governments is estimated to be $800 million in the first year, and $1 billion thereafter, with an equal amount paid by employees. Moreover, the costs of coverage would increase as salaries increase.

Schools and other state and local agencies do not have the resources to absorb the added cost of Medicare coverage for noncovered employees. Many states and localities are already hard-pressed to meet operating budgets, and they would be forced to reduce services -- including education programs -- to meet the sudden, dramatic costs of coverage. Some 23 states were forced to cut FY87 budgets, and 19 states are projected to cut FY88 budgets below FY87 spending.

The alternative to cutting services is raising taxes. In the past three years some 14 states and a number of localities have already raised taxes. In FY86 alone, nine states increased the sales tax, eight states increased the gasoline excise tax, and three states increased the personal income tax. In FY87, 20 states have already raised taxes and 8 other states are considering tax increases, in most cases just to maintain existing services.

The devasting fiscal burden of mandatory Medicare coverage for uncovered employees would exacerbate a number of factors which have severely limited the ability of local governments -- including school agencies -- to maintain and improve services. Over the past six years, there has been a dramatic decrease in all areas of federal assistance to state and local governments including federal education programs. Other cuts in federal assistance to state and local governments, including the elimination of $4.6 billion in revenue sharing and the elimination of federal income tax deductions for state sales taxes, have put states and localities between a rock and hard place.

At the same time, state and local agencies have had to contend with tax limitations, including statutory or constitutional restrictions on increases in property taxes. Moreover, communities throughout the country -- particularly in areas where the economy is dependent on energy, agriculture, and manufacturing -- have experienced dramatic downturns in their economies which have further reduced revenues.

In short, the impact of this proposal on schools in affected states and communities -- in concert with other revenue restrictions, reductions, and economic setbacks -- would mean more than cuts in so-called frills. This proposal could, in many areas, result in the elimination of entire educational programs and staff layoffs.

Impact on Individuals

Today, some 600,000 NEA members concentrated in 14 states work in jobs not covered by Medicare. It is generally accepted that education employees, including certified teachers, are still paid far less than their counterparts in professions that require similar skills and training.

The salaries of education employees would be adversely affected in two ways. First, the average increase in payroll taxes for these lower and middle-income employees is estimated to be almost twice the average decrease in general income taxes under the Tax Reform Act of 1986. Second, with the large sums state and local agencies would need to pay this additional payroll tax, school districts and other government entities would not have funds to provide compensation increases, either for mere cost-of-living increases or to enhance incentives to attract and retain qualified school employees.

Given education reform efforts intended to upgrade standards or responsibilities for education employees, individuals would be asked to do more for less even at a time when they are being asked to do more with less.

Mandatory Medicare coverage would not result in improved benefits for many public employees. Employees in the noncovered states have established alternatives for health care coverage after retirement, often in connection with their retirement plans.

At a time when we need to create new incentives to attract and retain qualified individuals in education careers, the imposition of mandatory Medicare coverage with its resulting decrease in take-home pay would serve as a disincentive for persons to enter and remain in education professions.

Congress Has Rejected Coverage for Current Employees

In the last two sessions of Congress, the issue of extending mandatory Medicare coverage to current state and local employees was full debated, analyzed, and rejected. We recognize that Congress has a number of difficult choices in its effort to reduce the tremendous projected federal deficits and enormous federal debt. However, the answer is not to shift such a severe burden to a limited segment of the population. Vital public services -- including education, police and fire protection, and other services important to the health and safety of whole communities -- would suffer disproportionately from a proposal that would have only a neglible, short-term impact on the federal deficit.

Current law will, in short time, bring all public employees under the Medicare system. The turnover rate for state and local employees is about 9 percent a year. This gradual phase in will allow public employers to adapt to the change with careful budget planning, rather than throwing a monkey wrench into the operation of the affected states and communities.

We urge the Committee to reject any proposal that would mandate Medicare or Social Security coverage for current state and local employees.

Thank you.

Mr. PICKLE. We thank you, and I want to thank the panel for your good testimony. You have been very helpful.

Mr. Cooksey, Mr. Lardis, and Mr. Sweeney, it would seem to me that you are saying that you would endorse any kind of revenue raisers so long as it does not affect the State and local government. Is that essentially correct?

Mr. SWEENEY. Essentially correct, Mr. Chairman, if it interferes with our traditional——

Mr. PICKLE. In other words, do not tax me; tax that fellow behind the tree, or someone else. But because of what is happening to you and your decreased revenue for cities or municipalities and counties, you would want to tax other people.

Now, I can understand that position, and I also want to add, Mr. Cooksey, that I was impressed by the fact that while you spoke as an individual and not the National League of Cities, you did point out three areas, as I remember, in which you said there could be some revenue raisers: stock transaction tax, income tax rates, perhaps as much as 30 percent, and some kind of tobacco tax. Well, that is helpful, and I know although you speak as an individual, at least you recognize the problem that we face.

I guess it is a tough decision for those of us here. I know one of you said that you are fearful that we might have a national sales tax. Has that been proposed by anyone?

Mr. SWEENEY. No. It has been discussed, Mr. Chairman. The VAT has been discussed as an option around here for a long time.

Mr. PICKLE. And when you say national sales tax, you really had in mind the value added tax?

Mr. SWEENEY. Value added tax is a sales tax, however clouded. This generates a lot of paranoia amongst us that collect sales tax.

Mr. PICKLE. Ms. Dix, with respect to the extension of Medicare coverage to State and local employees, you said we ought not do anything because in 1986 we said we would do it prospectively. You said in a short time all will be covered and that there is a turnover rate of 9 percent per year. How long would it be until most of the State and local employees would be under Medicare?

Ms. DIX. I do not have that figure.

Mr. PICKLE. One year? Two, three, five years?

Ms. DIX. I do not have an exact number on that with me. I would be happy to provide it for you at a later date.

Mr. PICKLE. I am trying to determine what kind of a turnover there is and how long would it be before they are all covered.

Ms. DIX. The numbers that we have indicated that there is about a 9 percent turnover each year in State and local public employees. So to the extent that those people are replaced as they leave public service, those people who are coming in as new hires would be covered under Medicare.

Mr. COOKSEY. Mr. Chairman?

Mr. PICKLE. Yes?

Mr. COOKSEY. I am advised that that figure is probably around 7 or 8 years.

Mr. PICKLE. Seven or 8 years for 100 percent.

Ms. DIX. Most.

Mr. PICKLE. Well, I would presume, though, it might be 7 or 8 years; the bulk of them would be covered within 4 or 5 years? Is that a good estimate?

Mr. COOKSEY. Roughly.

Mr. MOODY. I think, Mr. Chairman, the 7 or 8 years refers to most, not all. So 7 or 8 would be most.

Mr. PICKLE. All right. Now, Mr. Lardis, you seem to support increased Federal tax on tobacco and alcohol. That is a Federal tax, but we have many people on the State level who oppose that because they say that is an invasion of the State's tax base. You would still recommend raising revenue by a Federal tobacco and alcohol tax?

Mr. LARDIS. Yes, sir. There is probably room there for both political entities to enter into it. I think that you have got to find money somewhere, and if you are going to respect our traditional sources, that might be one area that you would consider.

I would suggest on my own—and I do not represent the association on this next statement—with respect to reductions, in order to bring your budget into a meaningful balance, you know, I cannot afford to protect 39,000 citizens. They are needy. We have a problem in a county which is a part of the United States of America, yet we give millions and millions of dollars to other needy citizens in foreign countries. The foreign aid bill, the World Bank, the International Monetary Fund—we spend a lot of money in those areas. Yet I cannot get a police car out to a needy citizen in Trumbull County, Ohio?

Mr. PICKLE. Well, I am trying to see the connection between foreign aid and your inability to get a car out there. We have a unified budget, and we have to look at the whole package and not just any one item vis-a-vis the other.

Well, we will ask Mr. Frenzel if he has any questions.

Mr. FRENZEL. Thank you, Mr. Chairman. I would like to thank the panel for its testimony.

I would like to ask Mr. Sweeney to tell me, if he can, what is the position of the Governors' Association with respect to excise taxes? You have told us that your group, the Association of State Legislatures, is vigorously opposed. Have the Governors been heard from on this subject?

Mr. SWEENEY. I do not know if the committee, Mr. Frenzel, has heard from the Governors' Association, but traditionally, they parallel our thought that you cross-interfere with what are traditional sources of incomes to States. They generally are opposed to that.

Mr. FRENZEL. Yes. That is what I would have suspected, but I have not seen any of their material this year. Apparently, they do not care anymore. They have gone to sleep.

Mr. SWEENEY. No. All the Governors are in New Hampshire this year, sir.

Mr. FRENZEL. Well, it is summer. That is the place to go, I guess.

I would like to ask Mr. Stifter, do you consider an extension of the FUTA tax, the extra two-tenths of 1 percent which seems no longer to be needed, a kind of a jobs tax? Is that the problem with it?

Mr. STIFTER. It is a payroll tax, and it was specifically put in place to pay off a loan and that loan has been paid off. There is not

a need in the system for that additional two-tenths at the present time.

Mr. FRENZEL. Thank you.

Ms. Dix, you indicated that 9 percent of public employees turn over every year. But is it not the same 9 percent that is turning over, so that we are never going to get the veteran employees until retirement, which is a much slower attrition than the total 9 percent turnover?

Ms. DIX. Well, according to the research that we have had an opportunity to review, that may be true to some extent. But there is also contained in that 9 percent people who are retiring from the system and moving out of the system to some other kind of employment for higher wages or better compensation or benefits.

Mr. FRENZEL. Of course, that is true. But I think it would be misleading if we let the committee believe that 9 percent turned over and it was a fresh 9 percent every year. I believe that it is going to take us not a few years to get most of those people out, not 11 or 9 years to get them all out. It is going to take us decades to get them out.

I would like to ask Mr. Sweeney again, in your testimony there is a terribly interesting map purporting to show—well, maybe I will ask you what it shows. It says State budget cuts adopted in the fiscal year 1987 budget, and the States are cross-hatched which have adopted cuts. Am I wrong or do I not see Ohio among those cited for valor?

Mr. SWEENEY. Cited for what, sir?

Mr. FRENZEL. For having made cuts.

Mr. SWEENEY. Ohio has made some significant cuts.

Mr. FRENZEL. But it is not cross-hatched.

Mr. SWEENEY. No, it is not.

Mr. FRENZEL. On the other hand, I see Minnesota cross-hatched, and it distinguished itself by increasing every item of spending that it could possibly get its hands on and some that it could hardly reach.

What, then, does the map mean? If Ohio cut and does not get credit, and Minnesota spent money like a drunken sailor and is credited, what does the chart mean?

Mr. SWEENEY. Let me suggest that Ohio did not have a reduction in cuts. We had some cuts in very selected areas, and I think anticipated growth was not realized and the like; and that we made some dramatic cost shifts.

These budget cuts that are represented in the cross section are in wherever areas that States have had to cut because of dedicated or general revenue money; they deserve, then, to have a designation as a cross-cut.

Mr. FRENZEL. Then my State that increased its spending 12 percent gets a hero badge?

Mr. SWEENEY. Gets a hero badge—well, it is difficult to answer that one.

Mr. FRENZEL. Perhaps you could show the States in money, if you would like us to be impressed by figures such as this. Does your conference have that capability to show what they spent last biennium?

Mr. SWEENEY. We certainly do. Yes, sir.

Mr. FRENZEL. I think if they put it in dollars it would make more sense for us.

Mr. SWEENEY. You mean a State-by-State return?

Mr. FRENZEL. Well, if it is important to hear testimony to show that the States are being squeezed and had to do some reductions, then at least as one member of the committee, I would like to see what those reductions were.

Mr. SWEENEY. Okay. Thank you. We will try to feed that information to you.

Mr. FRENZEL. Mr. Chairman, I thank you and yield. And, again, I thank the panel.

Mr. PICKLE. Now the Chair will recognize Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

I would just like to note two of the greatest protectors of the State and local employees who are not now paying their fair share of the Medicare tax fund. Mr. Gradison is not here. Mr. Pickle is well known among those of us who might even dare to suggest that State and local employees pay into the trust fund, and I would say to the witnesses from Ohio and from Texas representing the NEA that they have some real champions.

Because I am often asked to raise the issue, I could be persuaded, I guess, to switch sides and not tax State and local employees. One alternative to it might be to somehow deny them participation in the Medicare program if, in fact, they never paid into it. Would the NEA support that and, in effect, not let them get spousal benefits or benefits from other employment, if, in fact, they had——

Ms. DIX. Did I understand the question correctly to be to deny them participation if, in fact, they have paid in?

Mr. STARK. If they have not paid in, though, within the last 10 years.

Ms. DIX. If they have not paid in?

Mr. STARK. No. Say within the last 10 years before they retire. In other words, there are many of us who are either Federal or State or local employees who qualify prior, or in addition to part-time work, for Medicare.

Ms. DIX. And that is, in fact, the case for many of our members who are able to qualify for Medicare coverage just from the fact that they worked summer jobs or they work a second job.

Mr. STARK. But just do not pay as much as the rest of us.

Ms. DIX. Well, no. They are able to participate and benefit by virtue of having earned a number of quarters——

Mr. STARK. I understand that.

Ms. DIX [continuing]. In order to bring their income level up to something that makes ends meet, in addition to doing summer employment. That would be throughout the course of their career in teaching. It would be some 15 or 20 years.

Mr. STARK. Mr. Cooksey, maybe you can help me understand. What is roughly the gross payroll of Austin?

Mr. COOKSEY. Well, we have a personnel cost from our general fund budget that is about 65 percent of that general fund budget, which is $200 million. So it would be in the neighborhood of $125 million in the general fund. Then we have an electric system that we run in the city of Austin that has a substantial personnel cost. The major cost on that part of our budget, of course, is fuel.

I think as I recall it it is around 35 percent of the electric department's budget, which is about $500 million. So that is about $150 million there. That would be about it.

Mr. STARK. $150 million.

Mr. COOKSEY. $150 and $135 would be $285 million.

Mr. STARK. Your figure of $700,000 in cost to the city would be net of what you now pay?

Mr. COOKSEY. Yes.

Mr. STARK. In other words, you are providing retirement medical benefits for your workers now; is that correct?

Mr. COOKSEY. Yes. Actually, the only people who are not presently in the Social Security system in Austin are our firefighters. That really represents the cost of putting our firefighters in.

Mr. STARK. How much is their payroll, roughly? I would figure it backwards to say it has got to be $46 million in round figures.

Mr. COOKSEY. Yes.

Mr. STARK. Is it that high?

Mr. COOKSEY. Yes, it is probably around there.

Mr. STARK. Now, do they not have a retirement medical benefit, though?

Mr. COOKSEY. They have a retirement program, and I am sure that they also have——

Mr. STARK. I guess what I am getting at is would there not be a saving. One-and-a-half percent of $46 million is around $700,000, but would there not be a savings if they went into Medicare for retirement benefits that you would not have to provide that you are currently providing?

I am always getting the cost. Nobody ever talks to me about the savings.

Mr. COOKSEY. Well, I accepted these figures from my government finance officer, and I always accept their figures. She is always right.

Mr. STARK. Ms. Dix, do not most teachers have a retirement medical benefit?

Ms. DIX. In those States where teachers and other education employees are not covered by Medicare currently, they generally have a system of their own, and they feel that that system is better for them. It is more beneficial for them.

Mr. STARK. But does it cost something?

Ms. DIX. Oh, yes, and there is a payroll deduction for that that goes to their State or whatever.

Mr. STARK. Do you have any figures on how that compares with what Medicare would cost?

Ms. DIX. We do. I do not have figures with me. Generally, those systems are better for them than Medicare, provide better benefits for them than Medicare.

Mr. STARK. And cost more.

Ms. DIX. And generally it is a higher payroll deduction.

Mr. STARK. So if they paid Medicare, they could still get the extra benefits on top, right?

Ms. DIX. If they have earned the requisite number of quarters for Medicare during other employment.

Mr. STARK. Well, if they paid for Medicare, they would. I guess what I am missing somewhere along the line is—I mean, it is your

understanding about 90 percent, or more than 90 percent of all public employees qualify for Medicare one way or another. Do you not generally——

Ms. DIX. I would think for our membership that is probably true because of the amount of employment they do outside of their teaching careers, outside of the education.

Mr. STARK. And it just means that they are not paying the full fare. That is all. It hardly seems to be fair. That is all. They are going to get the full benefits.

Ms. DIX. And generally they have paid the full fare.

Mr. STARK. Yes, but only for a little while. In other words, they are not paying—as most of us have to—all our lives. That is the difference. You could pay for just the 10 years early on and then never pay again. And for somebody who works from the time they are a teenager until they are 65, they are paying for 45 years. That, I guess, is the equity issue.

Ms. DIX. But from their perspective, the equity issue is that they have met the requisite number of quarters the same as others have met the requisite number of quarters and, therefore, they should receive the benefit—unless for some reason the requisite number of quarters is changed and they no longer meet that definition.

Mr. STARK. I understand the position.

Ms. DIX. Just to make another comment on your earlier question, though, I think that on the savings issue, the reason that our members feel very strongly about their own State retirement system or whatever other system is in place for them where they were covered by Medicare right now, even though it is a larger payroll deduction for them in their current setup, they feel that they get the better benefits by virtue of participating in that system. A system that they have worked on and helped to bring into place appeals to them.

Mr. STARK. I would just like to comment on that because General Motors and some of the people in that industry who have—I do not know whether General Motors does, but some auto companies have unfunded medical retirement liabilities, and there has been a move to have a two-tier system for Americans who receive medical care when they are retired. That is exactly what we are trying to avoid.

It seems to us that all employees should pay into the same system and all employees should get equally good benefits. We should not have a two-tier system in this country for providing that kind of insurance. So, while I can understand that some benefits may be better, we do not think that is good public policy.

Thank you very much.

Ms. DIX. I would have to agree with you there and say that organizationally we agree with, and I think most of our membership would agree with you there. But they feel that it is not by their own doing that they find themselves in their current predicament. It is by virtue of the fact that they were, in fact, not permitted to participate in the system when it was established. They were forced to go out on their own and build something that turned out to be better from their perspective than Medicare is right now.

Mr. PICKLE. The Chair recognizes Mr. Rangel.

Mr. RANGEL. Ms. Dix, are you saying that you think that a drastic change of the law is what your employees are opposing; but that

if, indeed, the State did pay for Medicare expenses and if employees did have coverage under Medicare, that they could have a supplementary type of health plan when they retire to make certain that they did not lose any of the benefits that they have under their private plan, that the cost would be relatively the same except the Congress and the Nation would be able to get more people in the Medicare pool.

So the concept does not bother you at all now that everyone can come under Medicare, that as long as the teachers' unions are able to negotiate better benefits for the employee, you would have no problem with a mandatory public employee coming under this. It is the time plan or how it is done that bothers you most of all, is it not?

Ms. DIX. That has been the biggest concern for most of our membership. The fact that they have negotiated something previously that they have bought into and believe in, and they feel that this is sort of a change of the rules in the middle of the game for them. In addition, they are already paying a higher payroll deduction for their own system.

Mr. RANGEL. But you keep saying perception which means, I think, that it could be that many of the employees might come out ahead with mandatory Medicare deductions. It is just a question of working out a package which would include Medicare and other benefits.

Ms. DIX. I would have to agree that probably some of them would come out ahead. Many of them right now feel that their own State system—California and Illinois are two in particular that offer better benefits for the retiree than the Medicare system would offer.

Mr. RANGEL. Well, they are paying for a better system, but if a part of the contribution would be to the Medicare system, a lesser amount would have to be paid to bolster that system. So it would seem to me that the retiree would be concerned with the full package of benefits that they would receive and whether part of it was Medicare and supplemented by some other plan. As long as your employees would know that they are not losing any benefits and, in certain cases, may have increased benefit, and if the rules were not changed so dramatically that they would not understand that their total position is not being changed to their detriment, it should not make any difference whether part of that was mandatory for Medicare payments.

Ms. DIX. I personally believe that they should not make any difference. That is an idea that I would certainly like to have the organization and the membership take a look at, especially in those 13 or 14 uncovered States where members have very strong feelings about this issue.

Mr. RANGEL. Well, I could agree with you.

Ms. DIX. But I understand the point that you are making, and I do agree that——

Mr. RANGEL. When people negotiate and they know what they have, then certainly they would want those rules not to be changed until they see that they are not going to lose anything under that.

Ms. DIX. Right.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. PICKLE. Now Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman.

Mr. Sweeney, you spoke about the turf of the States and that the sales tax and the excise taxes on cigarettes and gasoline should be more or less their preserve. Of course, interestingly enough, many of the States have large surpluses today, do they not? And they also will be getting surpluses on windfall from tax reform in certain areas, and there will be coming a windfall on Medicare reform which is going to affect Medicaid.

I guess if you shared it with the counties, which Mr. Lardis represents, you would not have as big a problem.

Mr. SWEENEY. Well, let me speak to Ohio first, because, one, we were "to be a windfall State" on a projected tax reform act that had not yet passed the Congress, and the thing that was interesting, the source document for all knowledge on that was the great tax journal called USA Today. They color coded States on who was going to get what money, and immediately that became a cause from demagogues, politicians and disc jockeys to say do this with it and do that with it and return the windfall from tax reform that had not yet been realized.

And we did exactly that, as imprudently as it may sound. Before you passed the tax act, we passed a re-indexing of our income tax to adjust to those figures that were forecasted.

Now, in my judgment, that was not very prudent, but that was also a gubernatorial campaign year, a very hot political race in a great number of legislative districts, and it became the theme of things to do. At the same time, the cities, in a kind of anemic voice, were asking us to save the revenue sharing side. We made that attempt, and I think that we addressed it this year in the budget. Most States are going through their budget cycles, are just completing their biennial budget at this point, beginning 30 June, and we just rolled out of that.

We were not a profit state by any measure. We have less than 2 percent put in a rainy day fund on a cash flow circumstance, and that is not—in the best judgment of the fiscal minds, it ought to be a little higher than that. We do not have States that I think are in fat city today.

It is cyclical. When we discussed, if you recall 1979 when the call from President Carter and Michael Blumenthal was to rid States of revenue sharing, to get rid of the whole revenue sharing program, and they talked about States being rich. They used revenue that were forecasted hiding in our pension funds to say that they had revenue. At the same time they were calling states rich, we were raising temporary taxes and cutting budget across the board. All across the eastern seaboard and the Midwest was the Rust Bowl reaction.

Today, our stabilization is a result of those tax increases. At the same time the shifts of the boom countries in the South and West, whether it is the oil or what have you, are having some real severe problems.

Mr. GUARINI. Let us get to the Federal deficit. You do agree that there should be revenue raised to diminish our deficit.

Mr. SWEENEY. Absolutely.

Mr. GUARINI. And that it should be a progressive type of a tax, not a regressive type of a tax?

Mr. SWEENEY. Well, I will tell you that I will not defend——

Mr. GUARINI. It should be graduated?

Mr. SWEENEY. I will not defend the regressivity issue. I think that that is an option the Congress should have. I think a progressive tax is certainly far more productive as a source of revenue.

Mr. GUARINI. All right. Well, of course, the sales tax that you advocated, on cigarettes and gasoline, of course, is a regressive tax.

Mr. SWEENEY. Very regressive.

Mr. GUARINI. All right. Now, what kind of taxes would you suggest that the committee consider? Estate and gift taxes? Luxury taxes? Surtaxes? What type of tax would you suggest that would be most palatable?

Mr. SWEENEY. On the options that are before you today?

Mr. GUARINI. That is right.

Mr. SWEENEY. I still think the income based tax and tax on profits is substantially better than interfering in the regressivity of a tax that is already hit.

This morning on the front page of the Plain Dealer was the fact that our county just put out an additional half percent sales tax that is going to the vote of the people to get support for their revenue to support the county side.

Mr. GUARINI. All right. The mayor of Austin, Mr. Frank Cooksey, you suggested raising the tax from 28 to 32 percent. What you are suggesting is that we revisit the marginal rates, and we do some tax reform again. Is that correct?

Mr. COOKSEY. If you want to call it reform, you may, but it is an adjustment of the rate.

Mr. GUARINI. So that you feel that the people in Austin and the people of Texas—of course, you represent one of the fastest growing cities in the United States. I congratulate you on having such a splendid city. You are the envy of most of the cities in our country because you have got real prosperity down there.

Do you feel that that would be the most acceptable type of a tax that would fit best knowing the economic situation of your part of the country?

Mr. COOKSEY. Well, I named three. I named the tax that Speaker Wright has suggested.

Mr. GUARINI. The securities tax and cigarettes.

Mr. COOKSEY. The security transfer, raising the marginal rate. I neglected to mention retaining the transitional rates for corporations which I think would be acceptable, and the cigarette tax.

Mr. GUARINI. Do you think a surtax on income would be acceptable, sir?

Mr. COOKSEY. I am not sure about that. I have not really studied the surtax issue, and I am not sure what that would——

Mr. GUARINI. What about a luxury tax?

Mr. COOKSEY. It would depend on what it is on and how it is structured.

Mr. GUARINI. Some form of a luxury tax you think would be acceptable in your experience?

Mr. COOKSEY. I am not sure. I have not studied luxury taxes as an option.

Mr. GUARINI. Mr. Sweeney, do you think a luxury tax would be palatable?

Mr. SWEENEY. Oh, certainly. There is a perception that you can tax——

Mr. GUARINI. Furs, jewelry, cars?

Mr. SWEENEY. Pardon?

Mr. GUARINI. Furs, jewelry, expensive cars—taxes of that sort?

Mr. SWEENEY. That probably would not bother most local governments or States.

Mr. GUARINI. Raising estate taxes?

Mr. SWEENEY. Would not essentially interfere with those things that go on right now.

Mr. GUARINI. Any other opinion from the panel in regard to those three taxes that I mentioned: estate, luxury or surtaxes?

[No response.]

Mr. GUARINI. Basically what you are saying is stay off our turf; whatever other taxes you want is all right with us. Is that the sum total of your testimony?

Mr. SWEENEY. Almost, except that what seems to miss the point here is that we are not special interest groups coming in here lobbying for the Association of Manufacturers. We are serving the same constituency that you are trying to serve.

Mr. GUARINI. Well, you are a special interest group in that your particular view represents the pulpit that you are speaking from. There is a difference at times between the different levels of government.

Mr. SWEENEY. Well, the different levels of government should understand, I think, the jurisdictions of responsibility and, consequently, its avenues to sources of revenue to provide the kinds of services that you give us responsibility for, that we inherently take as responsibility. I have 616 school districts in Ohio I have to worry about.

Mr. GUARINI. Maybe we have too many levels of government. In England they do not have States, so therefore they have counties and municipalities and they have their Federal Government. This is true about many other constitutional areas. We uniquely have grown up through a State process, so we put another State level in there which has become that much more expensive to administer government.

Mr. SWEENEY. Well, I do not think I would have characterized the creation of State governments as having thrown in a level of government.

Mr. GUARINI. Well, it was a constitutional compromise that took place with Benjamin Franklin that had to recognize realities of the day 200 years ago. But it does distort the politics and the equal representation of all our people if you really think about it.

Mr. SWEENEY. Oh, certainly. If you really want the Federal network to work, just repeal the 17th amendment. We will get right with God at least in one of the Houses up here.

Mr. GUARINI. Thank you.

Mr. PICKLE. The time of the gentleman has expired.

Mr. Pease, do you wish to inquire?

Mr. PEASE. Yes, sir.

Mr. PICKLE. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman. I will be brief.

I would just like to observe that if Austin is known to be one of the most outstanding cities in America, at least considered so by our chairman, certainly the Ohio Legislature is the outstanding legislature in America and ably represented today by my former colleague Patrick Sweeney. I am delighted to have him here with us.

Were it not for five counties in the 13th Congressional District, I would call Trumbull County, Ohio, maybe one of the outstanding counties of the United States. Glad to have Mr. Lardis here as well.

I want to make a point in relation to the discussion that went on previously between Mr. Stark and Ms. Dix of the NEA. Mr. Stark was suggesting that perhaps if public employees do not pay in the Medicare tax during the last 10 years of employment, they should not get Medicare coverage. You, Ms. Dix, were making the point that to qualify for Medicare coverage you really only have to have 40 quarters of coverage. That is the law.

I think it would be helpful in that regard to keep in mind that those who work all of their lives and pay the Medicare tax all of their lives still receive far, far more in Medicare benefits than they ever pay into the system. So it may well be that some public employees do not pay in as much as private employees, but the discrepancy is not very great when you look at what either employee gets by way of benefits during that person's retirement years. So I really think that the point that Mr. Stark makes loses some of its validity when you look at it from that point of view.

You do not need to comment on that. I just wanted to support your position.

Ms. DIX. Yes, sir. Thank you.

Mr. PEASE. I presume that all of our panelists, at least from the State and city and county level, would be opposed to any removal of the exemption of local government for motor fuel taxes. Is that correct?

[Panel nods affirmatively.]

Mr. PEASE. Mr. Chairman, I think the panelists made the point well, but I would just like to emphasize it, that there is a real crisis in local and State government across our country, particularly in local government which is severely limited in its options for raising money. I certainly believe that as Congress tries to raise $19.3 billion, we will not do so in a way that exacerbates the financial dilemma of State and local government. There has simply got to be a better way to do that than to further hamstring State and local governments in their ability to provide necessary services.

It is not necessary to respond to that either. I assume that you would agree with that point.

Thank you, Mr. Chairman.

Mr. PICKLE. Thank you.

Mr. Moody, do you wish to be recognized?

Mr. MOODY. Yes. Thank you, Mr. Chairman.

Mr. PICKLE. Mr. Moody, before you proceed, we have one more panel, and this will be the last panel of the afternoon. For the people who are here, the hearing will resume in the morning at 9:30 in this room.

Mr. Moody.

Mr. MOODY. Thank you.

I assume from your comments that none of you would object to, among the many options that we are looking at, our raising the excise taxes on cigarettes or alcohol. Maybe I should not put words in your mouth. Do any of you object to that, putting aside the regressivity argument which we are familiar with? Do you have any objections other than those?

Mr. SWEENEY. Mr. Moody, in my testimony we object to it because it is counterproductive. We will lose revenue when you raise your taxes on alcohol. Then consumption drops dramatically. We lose revenue that are our taxes on that same commodity; likewise, in cigarettes. And I know that sin taxes are easy because we certainly utilize that domain when we need to. We have just added 4.9 or a nickel to a pack of cigarettes effective July 1 of this year.

Mr. MOODY. Well, Mr. Sweeney, you are saying we should not do it because that would cut your revenue. Then, the converse of that, obviously, is then we should stimulate production so that it would increase your revenues. Why do we not cut the Federal tax on those items in order to give you more revenue? That is the logical outcome of what you are saying.

Mr. SWEENEY. Well, that is not the mission. If you are here to assist the State governments in production of revenue, there certainly are more prudent ways to go. But cutting the cigarette tax, I do not think is principal amongst those. I would just suggest that it would produce revenue for us, to enable us to tax that same source.

Mr. MOODY. My point is only that your proposition has a reverse side of it.

Mr. SWEENEY. Certainly, it has.

Mr. MOODY. That if we were to cut taxes on cigarettes, it would stimulate your revenue. While that may not be the optimum way of stimulating your revenue, it would still stimulate your revenue. But it may not be the optimum way of cutting them, doing other things may not be the optimum ways of raising revenue either. There are no perfect approaches here.

Mr. SWEENEY. No, there certainly are not. But in answer to your question, Mr. Moody, we do object because it does interfere and will cost us revenue. It will raise your revenue, and we will be a casualty of that production of revenue.

Mr. MOODY. But is not our society better off if we can reduce the consumption of cigarettes, particularly by your people?

Mr. SWEENEY. No question about it.

Mr. MOODY. And you do not give that weight over your need for revenues?

Mr. SWEENEY. When we passed the cigarette and alcohol tax, it is not a health issue, sir. It is a revenue issue. We reach in there and grab anticipated uses of that ill health disease. Those who want to smoke, fine; they will pay a tax to do so. That is a revenue that we use to fund a great number of services, and many of them health-related.

Mr. MOODY. You agree that raising revenues does cut consumption?

Mr. SWEENEY. Yes, it does.

Mr. MOODY. In fact, that is the basis——

Mr. SWEENEY. Temporarily.

Mr. MOODY. Well, is that not the basis of your statement that it cuts your revenue, not consumption?

Mr. SWEENEY. It will cut dramatically into our revenues because we have just experienced our own increase in taxes, everything from the underground cigarette—people slide across Kentucky, Indiana, Michigan to buy their cigarettes, so there is a short-term curve of real genuine loss of revenue to Ohio.

Mr. MOODY. Of course, those border effects do not work or are irrelevant for national changes.

Mr. SWEENEY. Probably not.

Mr. MOODY. So that we would not suffer that much. If they are only temporary revenue changes, perhaps you are overstating them.

Mr. SWEENEY. Well, I do not know if I am overstating them. We do anticipate a loss of revenue in the cigarette sales tax side if, in fact, the Congress moves with a tax on cigarettes. We anticipate that. We know it will be real.

Mr. MOODY. It may be temporary; it may not.

Mr. SWEENEY. It may be temporary, maybe not.

Mr. MOODY. But it would be nice to know the calculations.

Let me switch now to your gasoline tax. You also claim that a gasoline tax would sharply cut your revenue, an excise tax on gasoline not dedicated to user fees, but just an excise tax for general revenue purposes to reduce the deficit. You have a table here. Can you give me the methodology? How did you, for example, determine that Wisconsin, my State, would have a revenue loss of exactly $6,233,000 or whatever it is—a very precise number—based on a 10-cent increase in the Federal excise tax? How did you make that calculation?

Mr. SWEENEY. Well, we did that with elasticity, demand curves on just the same data given to us by the Congressional Budget Office and telling us how you arrive at your estimates. We use the same on its impact. It is a supply and demand analysis of what has been our experience.

Mr. MOODY. But is not this partial analysis, at best? Let me explain. If we fail to cut the deficit and interest rates go up, it is going to cause a concomitant loss in jobs and employment, which inevitably will follow. By the way, it is not that interest rates may go up. Interest rates will go up if we fail to cut the deficit in the analysis of many reputable economists I have seen.

When that happens, there will be less driving and there will be less consumption——

Mr. SWEENEY. When the interest rates go up?

Mr. MOODY. When the interest rates go up, there will be less employment.

Mr. SWEENEY. And consequently less motor fuel consumption.

Mr. MOODY. Absolutely.

Mr. SWEENEY. Certainly. Cycles in the economy will impact.

Mr. MOODY. Not cycles. This is a direct result of failure to reduce the deficit. So if you look at a tax like the gasoline tax that would yield, let us say, $8 billion, or $9 billion and forestall the failure to meet our revenue goal, it seems to me any complete analysis would have to factor in not meeting the revenue goal. What would that do

to gasoline consumption and, hence, to your revenues in Ohio and elsewhere?

In other words, if we do not meet our deficit reduction targets, we will see less revenue in your gasoline tax fund. If we meet our deficit revenue reduction targets, we will see more, or at least we will not lose. Therefore, if gas taxes help us meet that target, a full calculation—which this is not—may turn out to more than offset the effects of this table.

Mr. SWEENEY. Well, I am just not confident that that speculative formula is going to work in Wisconsin or in Ohio. I am confident that the cost of gasoline will change the habits as it has already done in this country. The reason states are moving around raising their gasoline tax at this point is that we have been successful in the public policy demand that we reduce consumption. We get more efficiencies out of the machines, and we try to drive people into lower consumptions and lower expectations. We will back into the car-pooling and the like, and that is going to result in less consumption and less taxes.

I have bridges to rebuild. I have highways to do. I have got cities that cannot move its commerce, that will drive its employers out because of its infrastructure. We have to support that kind of——

Mr. MOODY. So we should encourage more driving and not less driving in America?

Mr. SWEENEY. Well, I certainly do not want to interfere with it and drive it off the market by making some element that is prohibitive.

Mr. MOODY. I assure you we will not be driving it off the market. The question is the amount. But it is like the tax on cigarettes. We could take the converse of your statement and reduce the gasoline tax and you get more revenue. That does not seem to me to make any sense at all. There is nothing magic about the level it is at.

Mr. SWEENEY. Let me suggest to you, Mr. Chairman and Mr. Moody, 24, 36 months ago when it was anticipated that this Congress was going to, in fact, let go of the 11 cents on cigarettes, States then anticipated, one, picking up portions of it and increased revenue at the same time. So it is not as ludicrous as it may seem. It was discussed around here, and seriously, and maybe imprudently it was anticipated by a number of States that you were going to drop the 11 cents. As it turned out, you did not.

Mr. PICKLE. Thank you, Mr. Moody, and I thank the panel very much. I appreciate your cooperation.

Now, the next panel: Barry Lynn, Edward O. Fritts, William Gorog, John O'Toole, and DeWitt Helm.

[Pause.]

Mr. STARK [presiding]. If the panel could find their way to the table, we will proceed.

I am going to welcome the panel to the committee and ask them, so that all the members will have a chance to inquire at whatever length, if they would attempt—we have five witnesses on this panel—to summarize or expand on their written testimony. And for their own assistance, I will ask the scorekeeper to run the clock. It is not my intention to cut you any shorter than other witnesses. But if you would like to summarize in that period or comment on your testimony, without objection the full testimony will

appear in the record. We can move the hearings along so we can get to question you on your prepared testimony.

We will start out in the order that you appear. Mr. Lynn, the legislative counsel for the ACLU.

STATEMENT OF BARRY W. LYNN, LEGISLATIVE COUNSEL, AMERICAN CIVIL LIBERTIES UNION

Mr. LYNN. Thank you very much.

Several proposals before this committee involve removing the tax deductibility as a business expense of costs incurred for the advertising of certain controversial products; notably, alcohol and tobacco. It is my purpose today to demonstrate that these measures cannot responsibly be undertaken as a means of generating additional tax revenues precisely because of the constraints of the first amendment to the Constitution.

Although introduction of these proposals into the Internal Revenue Code would almost certainly raise revenue, as a matter of constitutional laws, it must also be determined whether a constitutionally forbidden purpose is also motivating these efforts.

I think, Mr. Chairman, several sponsors of this kind of legislation have indicated quite clearly that they want these measures to significantly decrease such advertisements, and that they, in fact, abhor the products that are being advertised.

Obviously, the Congress has broad latitude to decide how revenues are to be raised, but the power to tax is not unrestrained by the other provisions of our Constitution. The first amendment specifically bars governmental manipulation of speech; and whether that is done through direct censorship or the manipulation of the Internal Revenue Code, the effect can be identical: the elimination or reduction of disfavored viewpoints from the arena of public discourse.

The Supreme Court has quite properly deemed unconstitutional direct taxes on certain types of periodicals, as well as differing tax treatment of periodicals based on content or subject matter.

In fact, equal treatment of entire categories of speech is the central theme of the first amendment's jurisprudence. If Congress were to decide that no advertising costs should be deductible, there would arguably be a reduction in commercial speech which could prove inimical to the first amendment principle of full debate on issues. But there would not be present the additional evil of discriminating against disfavored subjects.

These proposals, however, entail a deliberate effort to make legislative judgments within the category of advertising costs about what subject matter is worthy of deductibility. Such decisions are totally dependent on judgments about the messages being uttered and are, therefore, utterly impermissible.

It is also, I think, disingenuous to argue that current advertising cost deductions are a kind of subsidy. If they are, then the definition of subsidy swallows the entire Internal Revenue Code. It is, in fact, not a subsidy as that is usually understood, not a grant to businesses, but a simple recognition that one needs to spend money in order to make money, which constitutes the net effort to be taxed.

Even in those cases where there is an arguably greater governmental largess involved, such as in the provision of a public space for a meeting, the allocation of the electromagnetic spectrum for broadcasting, or the use of the mails for commercial purpose, courts require content neutral and viewpoint neutral availability. One significant byproduct of governmental neutrality is that no one gets the impression that the government is specifically endorsing or blessing the views that are being expressed.

The obvious principal effect of these proposals is to make it more costly to speak in favor of—that is, to advertise—certain products that many other people do not like. There is a clear burden on commercial speech interests in those proposals that would inhibit advertising because the cost of such advertising could not be used to determine net taxable income. Advertising clearly constitutes first amendment protected activity.

Although prior to 1976, the Supreme Court had provided only limited first amendment protection to so-called commercial speech, any simple constitutional distinction between commercial and noncommercial speech has been eliminated in several landmark decisions, including the famous case of *Central Hudson Gas and Electric Cop.* v. *Public Service Commission.*

In summary, when you look at that case, using tobacco or drinking alcohol are generally awful activities. There is no serious argument that all tobacco or alcohol advertisements are generically or inherently misleading. And it is also unlikely that any restriction on these ads through Tax Code manipulation would directly advance any governmental interest in having people stop or reduce the use of alcohol or tobacco.

Restricting advertising in this way undoubtedly inhibits commercial speech to the extent that it discourages the use of corporate funds to advertise because it makes it more costly to do so. Its likely effect is to reduce the volume of tobacco or alcohol speech. Therefore, it will have the effect of reducing information about the availability of a lawful product. Information dissemination was a central purpose of the first amendment, and it is simply not a permissible governmental function to keep accurate information from the public in order to shape the public's opinions or alter its lawful behavior.

People in our society do, in fact, have the right to reject the significance of warnings or to accept the risk of certain dangerous activities. If they drink or smoke, they certainly have the right to do so. They have a collateral right to learn through advertisements that others support this decision.

Our system of government assumes and requires that every branch of government must make an independent judgment about whether its actions are consistent with the Constitution. Although I recognize that the first amendment is not generally within the purview of this committee, I urge that this be the central issue you consider in evaluating proposals which would deter the advertising of certain lawful products. Significant as revenues are to this government, to raise them in breach of a constitutional principle is to attempt a trade too pernicious to be acceptable.

Thank you very much.

[The statement of Mr. Lynn follows:]

TESTIMONY OF
BARRY W. LYNN
LEGISLATIVE COUNSEL
AMERICAN CIVIL LIBERTIES UNION
BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
REGARDING TAX TREATMENT OF ADVERTISING
EXPENDITURES FOR CONTROVERSIAL PRODUCTS
JULY 7, 1987

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify. My name is Barry W. Lynn and I serve as a legislative counsel for the American Civil Liberties Union. The ACLU is a national non-partisan organization of 250,000 members which is dedicated to the preservation and enhancement of the protections of the Bill of Rights.

Several proposals before this Committee involve removing the tax deductability as a business expense of costs incurred for the advertising of certain controversial products, notably, alcohol and tobacco. We must state our unequivocal opposition on First Amendment grounds to these measures as a means to raise revenues. It is our purpose today to demonstrate that these measures cannot responsibly be undertaken as a means of generating additional tax revenues.

The aforementioned proposals on controversial advertising are touted before this Committee solely as "revenue raising" options. However, their constitutional significance cannot be so carefully circumscribed, nor can they be viewed apart from the other contexts in which these proposals have been promoted. Although introduction of these proposals into the Internal Revenue Code would almost certainly raise revenues, as a matter of constitutional law, it must also be determined whether a constitutionally forbidden purpose is also motivating its passage. Congressman Pete Stark, a sponsor of a bill to bar tobacco advertising deductions, has already indicated his interest in having the proposal "significantly decrease" tobacco ads. Congressman Brian Donnelly's proposal regarding disallowance of tax deductions for advertising tobacco and alcohol is also predicated on an abhorrence of the particular messages in those commercial announcements, not solely or even primarily on its revenue implications.

Obviously, the Congress has broad latitude to decide how revenues are to be raised, but the power to tax is not unrestrained by the other provisions of the Constitution. The First Amendment specifically bars governmental manipulation of speech, and whether that is done through direct censorship or manipulation of the Internal Revenue Code, the effect can be identical: elimination or reduction of disfavored viewpoints from the area of public discourse. The Supreme Court has quite properly deemed unconstitutional direct taxes on widely-circulated newspapers and magazines, see Grosjean v. American Press Co., 297 U.S. 233 (1926), and general-interest magazines "even where . . . there is no evidence of improper censorial motive . . . This is because selective taxation of the press . . poses a particular danger of abuse by the State." see Arkansas Writer's Project, Inc., v. Ragland, 107 S. Ct. 1722 (1987). Where the intent, or effect, was to create a special burden on somehow disfavored forms of speech, the constitutional prohibition is even stronger. As the Court made clear in Police Dept. v. Mosley, "Above all else, the First Amendment means that government has no power to restrict expression because of its message, its ideas, its subject matter, or its content; the people are guaranteed the right to express any thought, free from government censorship." 408 U.S. 92, 95.

Equal treatment of entire categories of speech is a central theme of First Amendment jurisprudence. If Congress were to

decide that no advertising costs should be deductible, there would arguably be a reduction in commercial speech which could prove inimical to the First Amendment principle of full debate on issues, but there would not be present the additional evil of discriminating against "disfavored" subjects. These proposals, however, entail a deliberate effort to make legislative judgments within the category of advertising costs about what subject-matter is "worthy" of deductability. Such decisions are totally dependent on judgments about the messages being uttered, and are thus utterly impermissible.

It is also disingenuous to argue that current advertising cost deductions are a kind of "subsidy." If they are, then the definition of "subsidy" swallows the entire Internal Revenue Code. It is in fact not a "subsidy" as that is usually understood, not a "grant" to businesses, but a simple recognition that one needs to "spend" money in order to "make" money, which is the net effort to be taxed.

Even in those cases where there is an arguably greater governmental largess involved, such as in provision of a public space for a meeting, see O'Hair v. Andrus 613 F.2d 931 (D.C. Cir. 1979), the allocation of the electromagnetic spectrum for broadcasting, see FCC v. Red Lion Broadcasting, 395 U.S. 367 (1969) or the use of the mails for commercial purpose, see Bolger v. Youngs Drug Products Corp., 463 U.S. 60 (1983), courts require "content" neutral and "viewpoint" neutral availability. One significant corollary to governmental neutrality is that no one gets the impression that the government is specifically endorsing or blessing the views expressed.

On its face, of course, the proposals to disallow the advertising of tobacco or alcohol is "content" specific. It is only a bit more subtle to recognize most proposals as "viewpoint" specific as well. Admittedly, Mr. Stark's proposal would disallow deductions for any communication "informing or influencing the general public [or any segment thereof] with respect to tobacco and tobacco products", there are no commercial interests which discourage smoking, except perhaps manufacturers of nicotine-flavored chewing gum. Nevertheless, the obvious principal effect of this proposal is to make it more costly to speak in favor of (that is, advertise) products some do not like.

There is a clear burden on commercial speech interests in these proposals. They would inhibit advertising because the costs of such advertising could not be used to determine net taxable income. Advertising clearly constitutes First Amendment protected activity.

Although prior to 1976 the Supreme Court had provided only limited First Amendment protection to so-called "commercial speech", any simple Constitutional distinction between "commercial" and "non-commercial" speech has been eliminated in several landmark decisions including Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council 425 U.S. 748 (1976) (rejecting a state ban on publishing prices for prescription drugs); and Central Hudson Gas and Electric Corp. v. Public Service Commission 447 U.S. 557 (1980) (invalidating broad regulation banning promotional advertising by an electrical utility).

Any proposed ban or new federal regulation of any advertising must be scrutinized in light of the test articulated in Central Hudson, a construct essentially reaffirmed in Posadas v. Tourism Co. of Puerto Rico, 478 U.S.___, 106 S. Ct. 2968 (1986):

> At the outset, we must determine whether the expression is protected by the First Amendment. For commercial speech to come within that protection, it at least must concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is

> substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest. Central Hudson Gas v. Public Service Commission 447 U.S. 557 at 566.

Clearly, using tobacco or drinking alcohol are generally "lawful" activities under the Central Hudson analysis. Similarly, there is no serious argument that all tobacco or alcohol advertisements are generically, inherently misleading. (Where an individual advertisement is alleged to be "misleading", the federal Trade Commission can and does investigate the matter). It is also unlikely that this restriction would "directly advance" some "substantial governmental interest". If the advertising disappeared there is substantial doubt that persons would stop smoking or would not begin to smoke. Advertisements hardly have such a mesmerizing effect on a person that he or she becomes entranced and has no place to go but the nearest cigarette machine.

This is also clearly not the "least restrictive method" under Central Hudson of advancing the asserted governmental interest.

The ACLU generally supports the concept of "more speech" rather than suppressing speech. Nothing prevents the federal government from engaging in more vigorous funding of there agencies which could produce and distribute anti-tobacco or anti-alcohol materials. Indeed, I am unaware of a single supporter of advertising who would not concede that affirmative "anti-tobacco" messages are more likely to deter the onset of smoking than any reduction in cigarette ads. One review of the data notes:

> The concept of a media antitobacco campaign appeals to large segments of the public health community, primarily because experience with the Fairness Doctrine messages on television and radio from 1967 to 1970 was so successful. Several empirical studies have documented that the antismoking messages, which were produced by the major voluntary health organizations and the federal government, depressed cigarette consumption much more than prosmoking advertising encouraged it. This accomplishment was particularly impressive in light of the greater frequency of the latter and their greater concentration in prime time, as well as the amateurish quality of many of the antismoking messages. (Warner, et. al., "Promotion of Tobacco Products: Issues and Policy Options", 11 Journal of Health Politics, Policy and Law, 367 (1986)).

Restrictive advertising proposals before the Committee undoubtedly inhibit commercial speech. To the extent that it discourages use of corporate funds to advertise, because this is not deductible, and thus more "costly", its likely effect is to reduce the volume of tobacco or alcohol "speech." Therefore, it will have, the effect of reducing information about the availability of a lawful product. Information dissemination was a central purpose of the First Amendment. It is not a permissible governmental function to keep accurate information from the public in order to shape their opinions or alter this lawful behavior.

People in our society have a right to reject the significance or persuasiveness of health warnings or even to accept the risk of dangerous activities. If they smoke or drink because they like the taste, the stimulation, or even the

"image," they certainly should have the choice to do so. They have a collateral right to learn through advertisements that others support such decisions.

Our system of government assumes and requires that each branch of government must make an independent judgment about whether its actions are consistent with the Constitution. Although I recognize that First Amendment issues are not generally within the purview of this Committee, I urge that this be the central issue you consider in evaluating proposals which would deter the advertising of certain lawful products. 1 Significant as revenues are to this government, to raise them in breach of to constitutional principle is to attempt a trade too pernicious to be acceptable.

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Mr. STARK. Mr. Fritts, who is the president and chief executive officer of the National Association of Broadcasters.

STATEMENT OF EDWARD O. FRITTS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF BROADCASTERS

Mr. FRITTS. Thank you, Mr. Chairman and members of the committee.

NAB is a nonprofit trade association representing approximately 5,000 radio——

Mr. STARK. Mr. Fritts, we do not have the luxury of most of your constituents of having good microphones, and you will have to pull this one right up close to you, or your guests and the recorder will not be able to hear you. Thank you very much.

Mr. FRITTS. Thank you, sir.

NAB is a nonprofit trade association representing approximately 5,000 radio stations and 940 television stations across the Nation. NAB joins with other members on this panel and all others who participate as buyers, sellers, or creators of advertising time and/or space in opposing any attempt to reduce the deductibility of advertising expenses.

It is crucial at the outset of this discussion to impress upon the committee that commercial, over-the-air broadcasting is supported solely by the sale of advertising time. Unlike many of our competitors, such as newspapers, magazines and cable television systems, broadcasting has no subscription base. Any action which creates a disincentive to advertise will be most harmful to the thousands of local radio and television outlets.

While most of my testimony will focus on the business side of any reduction in deductibility, let me stress to the committee the equally serious consideration that loss of advertising revenue will impact on the ability of stations to serve their audiences.

The proposal to reduce the deductibility of advertising is based on the suggestion that some benefit of advertising carries past the year in which the advertising is expensed. The overwhelming volume of advertising is designed to alert the consumer to the availability of a certain product, perhaps at a certain location, at a certain price. The ability to take advantage of a July 4 sale for a new automobile or the price of a pound of peaches in August will do the consumer no good the following February.

Many advertisers employ strategies whereby persuasive messages are organized into waves or flights which aim for a cumulative effect which is not achieved by any particular spot. Also, much advertising is specifically intended to be short term in its relevance, such as the advertising of special sales or clearances.

The decay rate or the durability of advertising has not been clearly established by statistical researchers. In practice, advertisers employ media planning strategies which lead them to design advertising campaigns which assume that advertising exposures have limited durability in terms of consumer perceptions and recall.

Advertising is the lifeblood of most successful businesses, local or national. For every dollar expended on advertising, there is on av-

erage of $33 realized in sales which generates profits and taxes. The cumulative effect of the impact advertising has on sales is one of the major ingredients in a robust and growing economy.

There is no hesitation on my part to remind the committee that advertising is an ordinary and necessary expense geared to maximizing the sales of goods and services. A business expense in job training, research and development, public relations and advertising all lead a business to the same goal; that is, the sale of products, profits and taxes on those profits.

Should you suggest that the useful life formula be applied to advertising, why should not the same formula then be applied to research and development, public relations or job training, which are much more likely to extend beyond the year than the expense that advertising would take place in.

There is also the assumption that a smaller reduction in deductibility—say perhaps ten percent rather than 20 percent—would be less harmful. Treating advertising differently from other business expenses, even if initially done in small increments, separates advertising from other legitimate business expenses, and that discriminates against a vital segment of the economic chain.

The National Association of Broadcasters also opposes the elimination of tax deductibility for the cost of advertising and promoting of tobacco and alcohol products. Many of the objections I have raised concerning the broader deductibility proposals are equally applicable here.

In the area of tobacco product advertising and promotion, this Nation's broadcasters are prohibited by law from advertising any tobacco product save pipe tobacco and cigars. The use of warning labels and other disclaimers have already had some impact on consumption. Essentially, all the government can do to steer its citizens away from tobacco has been done. If the Government wishes to do more, then the next logical step would be to declare the product illegal.

The committee may also be confronted with proposals to disallow the tax deductibility of all advertising and promotion of alcohol products, which on television and radio are voluntarily limited to beer and wine. We are well aware of the concerns raised by the abuse or misuse of alcohol products. Broadcasters nationally and locally have been leaders in alerting the public to the dangers of abuse through many of our public service campaigns.

After extensive hearings in the last Congress, Members of the House and Senate familiar with this issue felt that new laws or restrictions on the advertising of beer and wine were not necessary to inform and educate the public as to the dangers of abuse or misuse of these products.

Mr. Chairman, in conclusion, broadcasting is in reality thousands of local radio and television stations, each paying their fair share of taxes. Changes in the tax treatment of advertising will be felt at these stations, and the local communities these stations serve will be the real losers.

Thank you.

[The statement of Mr. Fritts follows:]

STATEMENT OF EDWARD O. FRITTS
PRESIDENT AND CHIEF EXECUTIVE OFFICER
THE NATIONAL ASSOCIATION OF BROADCASTERS

Mr. Chairman and members of the Committee, I am Edward O. Fritts, President and Chief Executive Officer of the National Association of Broadcasters. NAB is a nonprofit trade association representing approximately 5,000 radio and 940 television stations across the nation. I appreciate the opportunity to discuss with you the proposal to raise revenues by reducing, or in some instances eliminating, legitimate business deductions for advertising.

BROADCASTING AND ADVERTISING

The NAB strongly opposes any attempt to reduce the deductibility of advertising expenses.

It is crucial at the outset of this discussion to impress upon the Committee the unique role advertising plays in the operation of a radio or television station. The success of a station is a direct function of advertising sold. Unlike other forms of communication, commercial over-the-air broadcasting is supported solely by the sale of advertising time. Any action which creates a disincentive to advertise will be most harmful to the thousands of local radio and television outlets.

Just as broadcasters are solely dependent on advertising revenue to sustain their business, broadcasters are also advertisers. In a highly competitive business, local radio and television broadcasters use advertising to build audience share. Proposals that diminish the ability to advertise will adversely affect all broadcasters, but especially those who are just beginning their operations. You need only realize the monumental problem faced by a new AM or FM radio broadcaster seeking to alert the local audience that there is a new radio station to listen to.

Clearly, broadcasters will suffer a double penalty from any attempt to reduce the deductibility of advertising as a proper business expense.

While most of my testimony will focus on the "business" side of any reduction in deductibility, let me take this moment to stress to the Committee the equally serious consideration of service to the public. All broadcasting stations are licensed to serve in the public interest. This responsibility has given the public local and national news, public affairs programming, public service campaigns and community outreach programs. Loss of advertising revenue will, of necessity, mean a reduction in our ability to serve our communities.

LIFE SPAN OF ADVERTISING

The proposal to reduce the deductibility of advertising is based on the suggestion that some benefit of advertising carries past the year in which the advertising is expensed. There is little or no evidence to support the idea of an extended benefit in advertising. In fact, common sense would seem to dictate the contrary. The overwhelming volume of advertising is designed to alert the consumer to the availability of a certain product, perhaps at a certain location and price. The ability to take advantage of a July 4th sale for a new Chevy, or the price of a pound of peaches in August will do the consumer no good in the following February.

The notion that advertising has an enduring effect is not new.[1] Ground breaking research by Zielske shows that advertising begins to be forgotten immediately after exposure.[2] As a Wharton Econometric study concluded, "even when the advertiser's intent is to use specific advertising as long as it is effective, previous studies have shown that this effectiveness deteriorates fairly quickly."[3] Much research supports the generalization that about three exposures within a short time frame (e.g. four weeks) are most effective.[4]

Many advertisers employ strategies whereby persuasive messages are organized into waves or flights which aim for a cumulative effect which is not achieved by any particular spot. Also, much advertising is specifically intended to be short term in its relevance, for example, the advertising of special sales or clearances. The decay rate or durability of advertising has not been clearly established by statistical researchers. In practice, advertisers employ media planning strategies which lead them to design advertising campaigns which assume that advertising exposures have limited durability in terms of consumer perceptions and recall.

UNFAIR TAX CODE TREATMENT

There is no hesitation on my part to remind this Committee that advertising is an "ordinary and necessary expense" for any business. Treating the deductibility of advertising differently than any other ordinary and necessary expense would be discriminatory. Advertising, in its most basic form, is designed to inform the consumer of the availability of goods and services. The sale of those goods and services is the bedrock of our economy.

Any "ordinary and necessary expense" is geared to maximizing the sale of goods and services. A business expense in job training, research and development, public relation and advertising all lead a business to the same goal. In light of that fact, is there any business or tax purpose to be served by discriminating against advertising?

The deduction of "ordinary and necessary expenses" is to be taken in the year in which the business expended money for that activity. In light of that, is it truly sound to suggest that the "useful life" formula be applied only to advertising? Yet, to the extent "useful life" now becomes the measure for deductibility of these expenses, the useful life of R & D, public relations or job training are much more likely to extend beyond the year of the expense than would an advertising expense.

To single out advertising for the purposes of determining deductibility is clearly discriminatory. Allow me to add that the Joint Committee Print of June 25, 1987, justifies an

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1. Schmalensee, R., The Economics of Advertising, (Amsterdam, Holland: North-Holland Publishing Company, 1972, p. 121).

2. Zielske, Hubert A., "The Remembering and Forgetting of Advertising," Journal of Marketing, January 1959, pp. 239-243.

3. Schink, George R. and Sima Fishman, "The Macroeconomic Costs of Limiting the Deductibility of Advertising Expenses," Wharton Econometric Forecasting Associates, Inc., June 1986.

4. Krugman, Herbert E., "Why Three Exposures May Be Enough," Journal of Advertising Research: The State of the Art, (New York: Association of National Advertisers, Inc., 1976), pp. 53-56.

arbitrary 20 percent loss of deductibility under the guise of an "assumed allocation." Yet, the print makes clear that any attempt to attribute an extended useful life to advertising is "difficult." In my opinion a more proper term would be "impossible" or "non-existent."

UNFAIR IN BUSINESS PRACTICE

While the proposal is discriminatory in tax treatment of advertising when compared to other ordinary and necessary expenses, it is also discriminatory among the methods of creating product awareness. Many businesses use advertising and promotional strategies to maximize the attractiveness of their products to the consuming public. Recently, there has been a disturbing trend in the migration of dollars from advertising to promotional activities.

Promotional expenditures are growing at a rate of 20 percent a year, whereas advertising grew at 7.9 percent in 1985 and an estimated 7.6 percent rate in 1986.[5] Since 1980, media advertising has shrunk from 45 cents out of every advertising /promotion dollar to 35 cents. Promotional spending has increased from 22 cents of every dollar to 30 cents. The remainder went to trade promotion.[6]

Promotional practices take on a variety of forms. It may be as simple as the use of "cents off" coupons, contests, tie-ins with activities in the community (such as sponsoring a float in a parade) or sponsorship of sports events. Most firms include a mix of advertising and promotion in their sales plans. The fact is that over the past few years the advertising market for radio and television has not been as robust as we might like. Already there is a migration of advertising dollars to promotion. What is unmistakable is that the deductibility proposal will greatly accelerate this trend. Any disincentive to purchase advertising will lead to greater expenditures in promotional activity. As I stated earlier, this will have a particularly detrimental impact on the broadcasting industry.

Let me be very clear. I am not before you seeking an equivalent tax on promotions. Further, I am not asking you to take any action to promote higher rates of growth in advertising or to seek an exalted position for radio and television advertising. It is essential, however, that the committee appreciate the impact that the loss of deductibility for advertising will have in the current marketplace. We seek no special assistance, but we request no further impediments be placed in the market.

STATE TAX PROPOSALS

It appears that taxing advertising is not a new idea. The proposal to reduce the deductibility of advertising was first discussed while the Senate was considering tax reform proposals during the last Congress. More recently, we have witnessed several states seeking additional revenues through taxes on advertising. The state of Florida recently enacted a 5 percent services tax which includes advertising, joining Hawaii, New Jersey and New Mexico. Other states such as Indiana, Mississippi, Nevada and Washington are now looking at similar proposals.

I do not offer the state tax proposals as a defense to the type of proposal suggested in the Joint Committee report. I do want the Committee to be aware that these state proposals will

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5. Wall Street Journal, August 26, 1986.

6. Television/Radio Age, December 8, 1986.

seriously harm employment and may actually reduce net tax revenue because the resulting decrease in sales will reduce revenues from state sales taxes. A federal proposal to reduce deductibility will exacerbate the loss of jobs and the resultant harm to the economy.

A Wharton Econometric study analyzing Florida's recent 5 percent sales and use tax estimated a job loss of over 10,000 positions when the tax is imposed, over 40,000 lost by the end of 1989. If the tax induces some media and advertising companies to leave the state there would be a higher job loss and an initial reduction in personal income of $600 million and $2.6 billion by the end of 1989.

In a survey of Virginia businesses who advertise, the University of Virginia found a state tax on advertising could "adversely affect" state and federal government income tax revenues. Further, such a tax would lead to a decline in sales of between $55.6 million and $66.7 million; with a resultant loss in state sales tax revenue of over two million dollars.

DEFINITION OF ADVERTISING

At the outset of any discussion concerning advertising, it will be a simple matter to identify those practices which would be subject to less than 100 percent deductibility. However, over a period of time I suggest that much of the advertising activities of a business would fall into grey areas in which precise definitions would be difficult if not impossible. For example, would the salary of a marketing director be divided between advertising and non advertising activities, some fully deductible and the rest only partially so? Would the handbill left by a neighborhood salesperson regretting the fact no one was home when he/she stopped by be an advertisement or some other marketing tool? Would "enhanced underwriting" of public broadcasting programming become, by IRS regulation, advertising and therefore less than fully deductible? Inaccurate definitions, arbitrary regulations and unworkable concepts create complexity, which seems contrary to the efforts of this Committee when it took the lead to simplify and overhaul our tax code in the last Congress.

FOOT IN THE DOOR AND THE SLIPPERY SLOPE

While I am clearly opposed to any change in the deductibility of advertising costs, I am fully aware of the task that confronts this Committee and the Congress generally. Deficit reduction is a problem that has few solutions, all of them difficult. Awareness of that fact makes it abundantly clear that current proposals to defer or amortize advertising costs only postpone the inevitable. With trillion dollar deficits, proposals that raise $10.8 billion or more will not suddenly sunset. Congress will act, if not now then in the future, to make permanent the revenue gained by the federal treasury from these measures.

Just as clear is the assumption that a smaller reduction in deductibility perhaps 10 percent rather than 20 percent would be less harmful. If my prior concern of the loss of deductibility becoming permanent is the "foot in the door," then this concern is the "slippery slope." By treating advertising differently from other legitimate business expenses, even if initially done in small increments, we have proceeded down the slope, absent any justifiable tax policy rationale, to reduce the marketplace role advertising plays. It is our sincere hope that the Committee rejects this proposal.

TOBACCO AND ALCOHOL

I have commented on the proposals in the Joint Tax

Committee print which speak to the more general deductibility proposals. I would now like to draw your attention to the proposals included in the print relating to the deductibility for advertising and promotion of tobacco or alcohol.

The National Association of Broadcasters opposes both proposals. Many of the objections I have raised concerning the broader deductibility proposals are equally applicable here. Clearly the treatment of advertising would be much different from other intangible costs that would still be fully deductible. Particulary with respect to the advertising of alcohol products (beer and wine), there would be a severe financial impact on radio and television broadcasters. Loss of deductibility for these product categories would set a precedent for similar actions in other product categories that raise health or social policy concerns: e.g., eggs, pork, sugar, off-road vehicles, over-the-counter pharmaceutical products and beef.

In the area of tobacco product advertising and promotion, this nation's broadcasters are prohibited by law from advertising any tobacco product, save pipe tobacco and cigars. These prohibitions enacted in several steps over the past 20 years were taken because of the deep and convincing body of science which shows tobacco consumption to be per se harmful. The use of warning labels and other disclaimers have had some impact on consumption. Essentially, all that the government can do to steer its citizens away from tobacco has been done. If the government wishes to do more, the next step is to declare the product illegal and all advertising would cease.

The Committee also is confronted with a proposal to ban all advertising and promotion of alcohol products, which on radio and television is voluntarily limited to beer and wine. We are well aware of the concerns raised by the abuse or misuse of alcohol products. Broadcasters nationally and locally have been leaders in alerting the public to the dangers of abuse. This is the critical difference between the two products: consumption of tobacco is per se harmful; it is the <u>abuse</u> or <u>misuse</u> of beer and wine which creates societal concern.

Let me add that the issue of beer and wine advertising had full and extensive hearings in the 99th Congress in both the House and Senate. Despite lobbying by groups concerned about this subject and heavy "grass roots" pressure, both houses declined the invitation to act. To the contrary, members of the House and Senate familiar with this issue felt that new laws or restrictions on the advertising of beer and wine were unnecessary to inform and educate the public as to the dangers of abuse or misuse of these products.

In closing, Mr. Chairman, I am sure there are those who see advertising as an unnecessary or perhaps extravagant expenditure, thereby justifying different and burdensome tax treatment. The advertising of goods and services is inextricably linked to the role of these same goods and services. Reduction of one will do harm to the other and the effect will be felt throughout the economy.

The harm to broadcasting will be exceptionally severe. In the minds of many, broadcasting is synonymous with the three major television networks. Broadcasting is in reality thousands of local radio and television stations. Changes in the tax treatment of advertising will be felt at these stations, and the local communities these stations serve will be the real losers.

Thank you.

Mr. STARK. Thank you.

Mr. Gorog, who is president of the Magazine Publishers Association.

STATEMENT OF WILLIAM F. GOROG, PRESIDENT, MAGAZINE PUBLISHERS ASSOCIATION

Mr. GOROG. Mr. Chairman and members of the committee, I am Bill Gorog, president of the Magazine Publishers Association, made up of 200 firms which publish about 800 consumer magazines. While I am the only representative of the print media here today, the American Newspaper Publishers join in the thrust of my remarks. ANPA represents nearly 1,400 newspapers across the country, and I understand that they will be submitting their own testimony in writing but ask that I inform the committee of their shared concern with any proposal to limit normal business tax deductions for advertising costs.

As a former Deputy Assistant to the President for Economic Affairs under President Gerald Ford, I believe I understand the difficulty of the task ahead of your committee and the Congress. In those years when I worked with your committee, we were wrestling with a $35 billion deficit. Today, the problem is much greater.

Today, no one wants to raise taxes, neither the Congress nor the taxpayers who have to pay them, and yet most Americans recognize the need to lower our budget deficits, and we applaud your efforts to address that goal. In striving to reach that goal, however, let us not make the mistake of distorting our tax system to limit or deny the deductibility of a legitimate expense and, in so doing, damage the vigor and competitiveness of American business.

If these tax proposals are adopted, advertisers could reasonably be expected to reduce total expenditures for advertising, and such reductions would directly cause a parallel reduction in editorial content.

Half of total magazine revenues come from advertising. It is not coincidental that most magazines have a 50-50 split between editorial content and advertising for it is advertising revenue that pays for the editorial content. It follows that the ability of magazines to continue to provide valuable editorial material to readers is directly related to continued support from advertisers.

Our Nation has always had a unique approach to the dissemination of information. Our press, magazines and newspapers, have always attempted to deliver information at the lowest possible cost. For over a hundred years, our Congress even provided for free delivery by the Postal Department to ensure low cost availability of certain newspapers and periodicals. Advertisers have provided the funds to continue this concept, and this legislation would be a serious blow to this proven system.

I share Representative Schulze's concerns about the problems faced by American industry. We compete in a world market where most of our competition is permitted to rapidly amortize plant and equipment, and where other expenses are totally deductible.

I would suggest, however, that our competitive position would be worsened if we placed this additional burden on the IBMs, the Fords, the Chryslers and the Procter & Gambles of our nation.

Your staff has pointed out potential severe problems of definition and administration. I would like to point out recent events in the state of Florida that emphasize the reality of those fears. A Florida law went into effect on July 1 imposing a 5 percent sales tax on State and national advertising.

As of this date, everyone is in turmoil, trying to define advertising, trying to draw the line between promotion, public relations and advertising.

The State is hiring hundreds of new people to administer the law and advertisers are cutting back and cancelling, TV, radio, newspaper and print campaigns.

The problems on a national scale would be horrendous. For example, what about the salaries of people in advertising departments? What about the millions of classified ads? What about international advertising? Complex compliance is inevitable and it will create disrespect for the tax system.

There is another of the staff options which I want to discuss separately because of its own particular serious connotation. And that is the proposal to disallow altogether the deduction of advertising costs for alcohol and tobacco products. The proposal raises serious public policy and constitutional questions.

I have friends on the political right who want to tell me what I can or cannot read, and friends on the political left who want to tell me what I can or cannot advertise. Both sides pursue vigorously their effort at censorship on the grounds of protecting the health, virtue and welfare of the American people.

My response to both groups is to reiterate the argument which Justice Brandeis raised over a half century ago, that the remedy for the perceived evils of speech is more speech. If the Government wants to cure the ills it perceives, it should develop programs to educate people. Bans do not work, yet censorship will have lasting adverse impact.

While we respect fully the goals of those who have introduced legislation designed to discourage consumption of alcohol and tobacco, we believe that Congress can achieve its goals by promoting more education for the American public without diminishing the right of an advertiser to advertise a legal product.

Mr. Chairman, we appreciate having the opportunity to appear before your committee and present our views.

[The statement of Mr. Gorog follows:]

STATEMENT BY
WILLIAM F. GOROG, PRESIDENT
MAGAZINE PUBLISHERS ASSOCIATION
BEFORE THE COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
JULY 7, 1987

Mr. Chairman and members of the Committee. I am Bill Gorog, President of the Magazine Publishers Association, a national trade association made up of 200 publishing firms which publish about 800 magazines generally devoted to subjects of consumer interests. While we have not previously appeared before your Committee, I am sure that you and members of the Committee are familiar with many of our member publications -- both national publications, like the Reader's Digest, Time and Newsweek, and city and regional magazines, like Texas Monthly, New York, and Los Angeles Magazine, which serve many of your districts.

We requested the opportunity to testify on an issue of tremendous importance to our members and to our industry -- the proposed limits on the deductibility of advertising costs which is included in the "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means."

While I am the only representative of the print media represented here today, the American Newspaper Publishers Association also is associating itself with the thrust of my remarks. ANPA is a non-profit, non-partisan trade association representing nearly 1,400 newspapers. Its membership accounts for nearly 90 percent of U.S. daily and Sunday newspaper circulation. Many non-daily newspapers also are members. Because my expertise is in magazines, my testimony centers on that information medium. I understand that ANPA will be submitting its own testimony in writing, but asked that I inform the Committee of its shared concern with any proposal to limit, deny or delay normal business tax deductions for advertising costs.

As a former Deputy Assistant to the President for Economic Affairs under President Gerald Ford, I believe I understand the difficulty of the task ahead of your Committee and the Congress. No one wants to raise taxes -- neither the Congress nor the taxpayers who have to pay them. Yet most Americans recognize the need to lower our budget deficits and applaud your efforts to address that goal. While I do not believe it is appropriate for me to suggest how someone else's tax burden should be increased in order to reduce the deficit, I believe I can add to what you already know about the function of advertising and its importance to the magazine publishing business, as well as why it should be a fully deductible cost of doing business.

Receipts from advertising represent approximately one-half of the total revenues of America's magazines. Without advertising revenues it would not be possible to reach magazine readers with the diversity of information available in todays periodicals at affordable cover or subscription prices. Advertisers could reasonably be expected to reduce total expenditures for advertising, including magazine advertising, if the same dollars no longer go as far after taxes, and they also are likely to seek out alternative, fully deductible promotional or sales expenditures.

It follows that the ability of magazines to continue to provide valuable editorial material to their readers is directly related to continued support from advertisers. Magazines are businesses, and like other businesses, they try to produce a profit for their shareholders. Most magazines must operate in highly competitive markets. Entry into the magazine publishing business can be very difficult. For every 10 magazine startups, eight can be expected to fail, yet the startup of new magazines over the years has offered American readers a rich diversity of new information on subjects ranging from psychology to personal

financial management to personal computing. American magazine readers have enjoyed a wide range of magazines providing a diversity of information in part because this is one of the few remaining businesses where the entry costs are relatively low. However, many of these startups would not have been possible if early support had not come from advertisers willing to try to reach a new market. New magazines are bound to suffer disproportionately when the risk of reaching a new market is increased by the added cost of advertising attributed to its decreased deductibility.

Advertising represents an indispensible part of the business sales effort. Nevertheless, it has been suggested that it is a nonproductive expenditure, or that it is less productive than other costs of doing business. Yet an expenditure for advertising is no less essential to the operation of a successful sales business than the money spent on research and development of the product or the training of the company's sales, research or management employees. For example, take the prospective computer buyer who starts his or her search looking at advertisements to see what is on the market and pouring through the dozens of new computer magazines that have emerged to serve that industry. The salesman at Computerland may never have had the opportunity to sell that buyer a new McIntosh if Apple had not devoted substantial expenditures in national and local magazines and on radio and television to introducing this new product to the American public. In fact, the availability of that advertising may have reduced other selling costs because of the information available to the consumer through advertising.

I would hope that your Committee will be guided by the arguments prepared by your staff against limiting the deductibility of advertising because I believe they are far more persuasive than the arguments which may be made in favor of a limitation. I would like to review those arguments and to offer some additional observations about them.

1. Advertising costs represent the costs of selling a product in the current taxable year. They do not create a separate and distinct asset, and therefore should be fully deductible in the year incurred.

To treat advertising costs otherwise would be contrary to good financial and tax accounting. No element of advertising is viewed as a tax expenditure by any Treasury or Congressional staff report. Since the Financial Accounting Standards Board, the Securities and Exchange Commission, most academics, and the tax law historically consider advertising expenses to be currently deductible, the rationale that some advertising expenses may create some future period benefit must fail. There simply is little if any evidence of future period benefits that result from advertising expenses.

2. Even if some portion of advertising costs theoretically may benefit future taxable years, it is only a de minimus amount. In any event, it is impossible to verify the degree of proper allocation of the benefits to future years.

Moreoften, it is the nature of the product being sold, rather than the advertisement, that gives rise to the theory that there is a lingering value beyond the appearance of an ad. For example, how long do you remember the price of broccoli advertised in a Giant or Safeway ad. But you may see an IBM or Apple computer in your office daily and observe a variety of automobile models every day which remind you of a particular product and may jog your memory about an advertisement. Nevertheless, if all advertising costs were subject to limitation, consider the inequity that might be visited upon the supermarket and one of its most important recurring costs.

3. The staff report wisely notes that it would begin to produce severe definitional and administrative problems to attempt to distinguish between ads which may tend to produce some value beyond one year, or to attempt to distinguish between advertising or promotional expenses on the one hand and fully deductible selling expenses on the other.

The Treasury, by regulation, would be forced to try to draw the lines which rule one type of marketing expense "advertising" and another not. Your Committee would be presented with a wide range of appeals for exceptions attempting to draw the line in the law between advertising and selling expenses. For example, is the free copy of a magazine or newspaper an advertising or a production expense? Is the salary of a marketing director to be divided by some formula between advertising and non-advertising? Unworkable concepts create complexity, high compliance costs, and disrespect for the tax system. When the tax law makes distinctions that are not economically real, it will produce unneeded confusion.

4. Your Committee has just emerged from producing the most comprehensive rewrite of the tax code in decades. A major feature of the debate was the attempt to achieve a more equitable match between expenses and income derived from those expenses. If the Tax Reform Act of 1986 was not viewed as the appropriate vehicle for reexamining the treatment of expenses for intangibles, then a reconciliation measure surely should not be used for this purpose. There are too many directly related and equally complex issues which should be addressed at the same time. For example, would it be appropriate tax policy to limit the deductibility of advertising expenses while permitting similar costs such as research and development, employee training programs, costs attributable to loan officers in financial institutions, or costs devoted to long-range corporate planning, to be currently deducted?

In addition to the arguments advanced against limiting deductions for advertising costs, the staff presents arguments in support of such a proposal to which I would also respond.

1. The staff report suggests that because benefits from the amounts paid for some advertising may extend beyond the year of the expenditure, deferral of the deduction for a portion of these costs would produce more proper matching of the costs with the income generated by them.

As I noted earlier, there is no Treasury or congressional study which makes this assertion, and there is little empirical data which we have found which supports this thesis. I would hope that the Committee would not act merely on an intuitive assumption.

2. The staff concludes that advertising costs do not lead to increased competitiveness; they merely shift consumer buying priorities. Thus there is no justification for a tax subsidy for these expenditures.

Nothing in the Internal Revenue Code requires that an expenditure contribute to competitiveness before it may be currently deducted. Nevertheless, every time an IBM or Apple advertisement help sell a personal computer, it enhances our country's competitiveness.

Also, it hardly seems appropriate to describe the ability to deduct a selling cost as a subsidy. How does this cost differ from the cost of producing a sample, or the salesperson's commission -- none of which would be characterized as being subsidized in a tax system where tax liability is based on net income.

3. The staff suggests that permitting a current deduction for advertising costs creates a preference for businesses that invest in advertising over businesses that invest in tangible assets or other types of intangible assets, the costs of which must be depreciated or amortized.

There is an old saying in the magazine business, that "your assets go down the elevator every night." Yet salaries for employees, whether employed in writing, editing, sales, planning or management are, appropriately, fully deductible as ordinary and necessary business expenses. Employees are not depreciable,

but it has not been suggested that an employee-intensive service company enjoys a tax preference over a company which invests more of its resources in tangible assets. Or what of companies involved in development of computer software or biotechnology -- do they enjoy such an preference because their research and development expenses are currently deductible?

4. In another suggestion, the staff says it may be appropriate to assume an appropriate period for allocating the benefits from advertising costs since it is impossible to determine precisely what portion of such costs benefits a particular year.

As the staff implicitly concedes, it is not possible to determine precisely whether or not advertising expense may benefit a future period. Simply to pick a percentage and disallow it as a current deduction is to impose a penalty on advertising that other obvious business expenses do not bear. The partial disallowance of entertainment expenses is an exception to the general rule largely because of a perception that allowing 100 percent deductions for many of these costs, which are essentially nondeductible personal expenditures, is unfair to other taxpayers. There is no element of personal expenditure here, and the choice by a company to allocate certain resources to provide information about a product and other resources to the direct sale of the product should not be second-guessed by the tax code.

There is another feature to the staff options which I want to discuss separately because of its own particularly serious connotations. That is, the proposal to disallow altogether the deduction of advertising costs for alcohol and tobacco products. As you know, this is a counterpart proposal to legislation pending before the Committee on Energy and Commerce to ban the advertising of tobacco products. Either proposal raises serious public policy and constitutional questions.

I have friends on the political Right who want to tell me what I can or cannot read, and friends on the Left who want to tell me what I can or cannot advertise. Both sides pursue vigorously their effort at censorship on the grounds of protecting the health, virtue and welfare of the American people. My response to both groups is to reiterate the argument which Justice Brandeis advanced more than a half century ago, that the remedy for the perceived evils of speech is more speech.

If government wants to cure the ills it perceives, it should develop programs to educate people. Bans don't seem to work, yet censorship will have lasting, adverse impact. I understand the growing concern in Congress about the possible regressive nature of attempting to reduce the deficit with increased excise taxes, including taxes on tobacco and alcohol products. But increased costs to manufacturers which result from limits on the deductibility of advertising costs are just as surely going to be paid by the consumer as the added costs from excise taxes.

I would imagine, however, that raising the caution flag of censorship in the area of tax policy may be met with some skepticism by members of this Committee. After all, it was Mr. Justice Douglas, in the 1958 Case of Commissioner v. Sullivan, who said, "Deductions are a matter of grace and Congress can, of course, disallow them as it chooses." That opinion was handed down years before the Court had recognized that commercial speech also enjoys a measure of protection under the First Amendment.

In 1983, the Court in Regan v. Taxation with Representation (TWR) upheld the denial of tax-exempt charitable status to non-profit organizations that lobby, while allowing veterans organizations an exception to that rule. Some advocates of tobacco advertising restrictions argue that this case stands for the principle that Congress need not subsidize a First Amendment activity for it to be realized, and that statutory classifications are valid if they bear a rational relationship to a legitimate government purpose.

However, in a critical part of the majority opinion, the Court said, "The case would have been different if Congress were to discriminate invidiously in its subsidies in such a way as to "'aim at the suppression of dangerous ideas.'" Mr. Justice Blackmun reiterated this point in his concurring opinion stating that ". . . a statute designed to discourage the expression of particular views would present a very different question."

Fifty years ago the Court struck down a Louisiana sales tax on large circulation periodicals which was designed to punish critics of Governor Huey P. Long. Correspondingly, the denial of a tax deduction can constitute the denial of a constitutional right. But one of the staff options would permit everyone to deduct advertising costs as an ordinary and necessary business expense -- except those who want to use the deduction for costs related to disfavored speech about alcohol or tobacco products.

The key distinction between the cases in which the Supreme Court has upheld the denial of tax deductions potentially affecting the exercise of constitutional rights is over whether the speech that would be affected is viewpoint neutral or whether the legislation is aimed at the suppression of ideas. In the case of the proposed revenue options affecting alcohol and tobacco advertising it appear to be the latter.

Proponents of legislation to prohibit the deduction of tobacco advertising costs have described the purpose as requiring the Government to speak with one voice. They want the government to send its message by limiting the rights of others to present their message. I would like to include in the record a memorandum prepared for MPA concerning "The First Amendment Tax Deductions for Advertising Alcohol and Tobacco Products."

While we respect fully the goals of those who have introduced legislation designed to discourage consumption of alcohol and tobacco products, we believe that the Congress can achieve its goals by promoting more education for the American public without diminishing the principles of a free press and of free speech.

Mr. Chairman, we appreciate having the opportunity to appear before your Committee and present our views. I hope we have helped to acquaint you with the very serious tax policy and constitutional problems raised by the staff options.

JAMES H. DAVIDSON & ASSOCIATES
INCORPORATED

JAMES H. DAVIDSON
PRESIDENT

SUITE 650
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202-293-2180

MEMORANDUM

TO: Magazine Publishers Association

FROM: Jim Davidson

SUBJECT: The First Amendment and Tax Deductions for Advertising Alcohol and Tobacco Products

DATE: July 7, 1987

The denial of the business expense deduction for the cost of alcohol or tobacco advertising raises substantial constitutional questions in light of the protection which the Supreme Court has accorded to commercial speech. An analysis of the constitutionality of bills designed to limit such deductions can be viewed in two parts -- the first addressing whether this is an impermissible use of the government's taxing power, and the second to examine the protection afforded commercial speech.

First Amendment Limits on the Taxing Power

CRS and the constitutional scholars who believe the denial of the tobacco advertising tax deduction -- or even a ban on all tobacco advertising -- is permissible, first rely on a line of Supreme Court cases granting Congress broad latitude in the classifications and distinctions used in tax statutes. Nevertheless, while Justice Douglas often is quoted in Commissioner v. Sullivan, 356 U.S. 27 (1958), as stating "Deductions are a matter of grace and Congress can, of course, disallow them as it chooses," it may be more relevant to examine the Court's opinion and Justice Blackmun's concurring opinion in Regan v. Taxation With Representation, 461, U.S. 540 (1983) (TWR) to understand the status of current law.

The Court in TWR upheld the denial of tax-exempt charitable status to non-profit organizations that lobby, while allowing veterans organizations an exception to that rule. Advocates of limitations on tobacco advertising deductions argue this case stands for the principle that Congress need not subsidize a First Amendment activity for it to be realized, and that statutory classifications are valid if they bear a rational relation to a legitimate government purpose.

In the most critical part of the analysis on this point, however, the Court said, "The case would be different if Congress were to discriminate invidiously in its subsidies in such a way as to "'ai[m] at the suppression of dangerous ideas,'" quoting from Cammarano v. U.S., 358 U.S. 498, at 513 (1959). Blackmun reiterated this point, stating that ". . . a statute designed to discourage the expression of particular views would present a very different question." The Court disallowed such discrimination 50 years ago in Grosjean v. American Press Co., 297 U.S. 233 (1936), deciding that a Louisiana tax on large circulation periodicals designed to punish critics of Governor Huey P. Long was "a deliberate and calculated device in the guise of a tax to limit the circulation of information to which the public is entitled."

The denial of a tax deduction could constitute the denial of a constitutional right. Bills pending before Congress to limit deductions for alcohol and tobacco advertising would permit

everyone to deduct the ordinary and necessary business costs for advertising -- except those who want to use the deduction for disfavored speech about alcohol or tobacco products. In TWR the Supreme Court said ". . . we have held that the government may not deny a benefit to a person because he exercises a constitutional right," observing that in Speiser v. Randall, 357 U.S. 537 (1958) it had struck down a California law denying a property tax exemption to individuals who refused to sign a pledge not to advocate the forcible overthrow of the government. The Court in Speiser said that "[t]o deny an exception to claimants who engage in certain forms of speech is in effect to penalize them for such speech."

The key distinction between the cases in which the Supreme Court has upheld the denial of tax deductions potentially affecting the exercise of constitutional rights is over whether the speech that would be affected is viewpoint neutral or whether the legislation is aimed at the suppression of ideas. In the case of the pending alcohol and tobacco advertising bills, it is clearly the latter. These bills would prohibit deductions for any amount paid or incurred to advertise any alcohol or tobacco product. Moreover, some sponsors have described their bills as requiring the Government to speak with one voice. Thus they want the government to send a message by limiting the rights of others to deliver theirs.

First Amendment Protection of Commercial Speech

The second issue confronting these bills is the protection which the First Amendment affords to commercial speech. The Supreme Court has recognized that protection since 1976 when it said the government may not attempt to manipulate behavior by curtailing access to information. Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc., 425 U.S. 748 (1976), striking down a state law prohibiting the advertising of prescription drug prices. In 1980, the Court said that for commercial speech to be protected it "must concern lawful activity and not be misleading. Next we must determine whether the regulation directly advances (emphasis added) the government interest asserted, and whether it is more extensive than is necessary to serve that interest." Central Hudson Gas & Electric Co. v. New York Public Service Commission, 447 U.S. 557 (1980).

Even if the alcohol and tobacco advertising deduction bills could overcome the constitutional objections noted by Professor Philip B. Kurland of the University of Chicago to the fact that they represent efforts "to regulate the content of speech in order to control thought as an alternative to controlling behavior," they would still fail the test of Central Hudson because it cannot be demonstrated that the denial of these tax deductions would "directly advance the government interest" -- that is, result in reduced alcohol or tobacco consumption. A 1986 study of eight free market countries and eight centrally planned economies for the International Advertising Association concluded that "advertising bans have not been followed by significant changes in tobacco consumption." If a total ban has little effect -- and has even followed by increased consumption in most countries, how can it be argued that these bills meet this critical test of Central Hudson?

Finally it will be argued that the Court's decision last year in Posadas de Puerto Rico Associates v. Tourism Company of Puerto Rico, 106 S. Ct. 2968 (1986) leaves to Congress the final decision over whether there is a sufficient link between the remedy and the result. Posadas upheld a Commonwealth law barring advertising of local casinos to Puerto Rico residents. It did not bar adds of casinos to tourists. Posadas should be restricted to the very narrow context in which it was decided, the fact that it did not approve a total advertising ban, the traditional deference the Court always has given to laws affecting the Commonwealth, and the fact that the Court did not rewrite or overturn the Central Hudson test.

Mr. STARK. Thank you. We will now hear from Mr. O'Toole, the executive vice president of the American Association of Advertising Agencies.

STATEMENT OF JOHN E. O'TOOLE, EXECUTIVE VICE PRESIDENT, AMERICAN ASSOCIATION OF ADVERTISING AGENCIES

Mr. O'TOOLE. Thank you very much, Mr. Chairman. I represent the American Association of Advertising Agencies, which is a group of agencies that place about 80 percent of the national advertising that is placed by agencies in this country.

Prior to taking this position, however, I spent 32 years in the advertising business itself. And it is from that perspective that I would like to comment on certain proposals to disallow or to postpone the deductibility of advertising expenditures.

In my written testimony I commented on behalf of our member agencies as to our dismay at the concept of taxing the elements that produce profit at the same time that you are taxing the profit itself. It has always been our understanding that government exacted its share of our net income, intelligently allowing deductions on expenses incurred during the production of that income.

I commented further on the inadvisability of disallowing or amortizing even a portion of advertising expenses since it would simply invite a general reduction in advertising volume, and a resultant reduction in sales volume, economic activity and jobs.

I commented, too, on the concern within the advertising community whenever government proposes to use its taxing power as a means to suppress the first amendment rights of any industry that it currently disfavors. If government can deny normal business deductions today for the tobacco or the wine or the beer industries, it can tomorrow selectively tax and silence any group or any individual who disagrees with any government policy.

But in the minutes remaining, I would like to challenge the concept that advertising, or any portion of it, can be construed as a long term asset that should be amortized over several years. The fact is, companies advertise to achieve immediate sales, and not sales next year or the year after. Large advertisers support continuity campaigns because they must maintain public awareness of the benefits that their products provide in order to maintain or to expand their current market share.

But these continuity campaigns are a series of messages, no one of which has a long term effect. It is their frequency, not their individual longevity, that maintains these awareness levels. To say that the advertisements that maintain awareness are long term assets is like saying that the gasoline that drives the truck is a capital investment.

What happens when a company stops such a sequence of advertisements? In a study that was conducted by Hubert Zielske of Foote, Cone & Belding, a company with which I was associated for 31 years, consumers were exposed to a particular advertisement repeatedly over a 13-week period.

Immediately after 13 successive weekly exposures to the advertising, 63 percent could remember it. However, within only 4 weeks after the last exposure, the percentage who could remember the ad-

vertising was cut in half. After 6 weeks it was decreased by two-thirds. Within 6 months, it was forgotten by virtually everyone.

Subsequent studies with television commercials that were broadcast for 13 weeks at 100 gross rating points showed almost identical results. Such memorability studies still form the basis of media strategy at Foote, Cone & Belding and at many other agencies.

Now this is not to say that consumers do not remember a product long after the advertising has run. Their awareness derives from a variety of sources, including advertising, but including word of mouth and personal experience as well. The key question, however, is whether advertising from past years has any appreciable effect on current sales.

Well, consumers look to pertinent current information to help them make current purchase decisions. The most their recall of older advertising can provide is name recognition or some feeling about the company. The sales message is lost. In most cases, even if it were remembered it would be inappropriate or outdated as far as the product's current marketing strategy is concerned.

And regardless of the effect of any single advertisement, almost half of all advertising cannot, by definition, have any impact whatsoever beyond the period when the costs of the advertising are incurred.

Consider these examples. Promotion advertising, designed to generate short-term sales results by offering cents-off saving or a refund or a premium or a contest. A.C. Nielsen says that they peak 6 to 8 weeks after the event.

Approximately a quarter of total advertising expenditures in 1985 was spent on direct response advertising. The typical direct response effort achieves 90 percent of its response in 4 weeks, the remainder in a maximum of 8 weeks.

Retail advertising—the largest category of all—is designed to achieve its objective within a matter of days.

In conclusion, the committee has asked that we as witnesses suggest alternative sources of revenue. I am an advertising man and not an economist, and I would probably cause as much mischief proposing tax concepts as economists do when they propose advertising concepts.

I will, however, reiterate our belief that the policy of taxing profit rather than the elements of profit is a prudent one. It is wiser to tax the golden egg than to dissect the goose and tax its parts.

Thank you very much.

[The statement of Mr. O'Toole follows:]

TESTIMONY OF

JOHN O'TOOLE

EXECUTIVE VICE PRESIDENT

THE AMERICAN ASSOCIATION OF ADVERTISING AGENCIES

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ON

THE TAX DEDUCTABILITY OF ADVERTISING EXPENDITURES

DELIVERED BEFORE

THE HOUSE WAYS AND MEANS COMMITTEE

JULY 7, 1987

THE A.A.A.A.

The American Association of Advertising Agencies (A.A.A.A.) is the national association of the advertising agency business. A.A.A.A. represents over 740 advertising agencies across the country. Together those agencies account for more than three-fourths of all national advertising placed by advertising agencies, as well as a substantial portion of local and regional advertising. The association provides its members with management consultation on a wide variety of issues important to their businesses and is instrumental in developing industry-wide positions and points of view. Additionally, the A.A.A.A. handles public and governmental relations for the advertising industry and maintains the largest library of advertising related research and data in the country.

SUMMARY

Recently, some members of the Ways and Means Committee have proposed that Congress look at the tax treatment of advertising expenses. Proposals have been introduced that would disallow the deduction of all or a portion of advertising expenses as a legitimate business expense. Other proposals would have advertisers amortize their advertising expenses over one or more years. Finally, proposals have been introduced to deny the deductability of advertising expenses for specific disfavored industries.

The A.A.A.A. believes that while these proposals may be simplistically appealing, they are, in fact, dangerously shortsighted. Proposals to disallow or amortize a portion of advertising expenses will not only fail to realize the anticipated revenue but will also have an adverse effect on the economy and place small businesses at a competitive disadvantage, if not in jeopardy. Singling out the advertising expenses of particular disfavored industries for special tax treatment would represent a direct infringement on those companies' First Amendment rights. The following arguments explain in detail why these proposals should not be considered as revenue-raising alternatives.

ADVERTISING IS A RECOGNIZED COST OF DOING BUSINESS AND, THEREFORE, SHOULD BE CONSIDERED A FULLY DEDUCTABLE BUSINESS EXPENSE.

In theory, as well as practice, the imposition of taxes in the United States is based on the premise that only net income may be taxed. Deductions are rightfully permitted for costs reasonably incurred during the production of that income. Allowance for the deductibility of advertising expenses, as with the deductibility of other business expenses, does no more than implement this net income concept.

Given this, the deduction for advertising expenses should in no way be considered a subsidy for the advertiser. It is no more a subsidy than the deductability of wage payments is a subsidy for the operation of failing businesses. These business expense deductions may only be characterized as subsidies if each and every exclusion from net income is construed to be a subsidy.

ADVERTISING IS USED TO PRODUCE IMMEDIATE SALES, NOT TO GENERATE LONG-TERM GOODWILL. THE EFFECT OF AN ADVERTISEMENT IS SHORT-TERM AND IT DOES NOT PROVIDE AN ADVERTISER WITH A LASTING INTANGIBLE ASSET.

It has been suggested that advertising provides benefits that extend well beyond the period in which it appears, and that, therefore, amortizing a portion of advertising expenses over one or more years would be appropriate.

Simply put, companies advertise to achieve immediate sales, not sales next year or the year after that. Large advertisers continue to advertise because they must maintain public awareness of the benefits their products provide in order to maintain their market share. They recognize that consumers have short memories and that, without a constant series of reminders, their products will soon be forgotten. But these continuity campaigns are, indeed, a series of messages, no one of which has a long-term effect. Their frequency, not their individual longevity, is what maintains awareness levels.

What happens when a company ceases such a sequence of advertisements? Research indicates that consumers quickly forget the advertising messages they have received. In a famous study conducted by Hubert Zielske of Foote, Cone & Belding in the late 1950s, consumers were exposed to a particular advertisement repeatedly over a 13 week period. Immediately after 13 successive weekly exposures to the advertising, 63% could remember it. However, within only

four weeks after the last exposure, the percentage who could remember the advertising was cut in half. After six weeks, it had decreased by two-thirds. Within six months it was forgotten by virtually everyone.

This is not to say that consumers do not remember a product that has been advertised long after the advertisement has run. Their awareness derives from a variety of sources including advertising, word of mouth and personal experience. The key factor, however, is whether advertising from past years has any appreciable impact on current sales.

Consumers look to pertinent current information to help them make purchase decisions. The most their recall of older advertising can provide is name recognition and some feeling about the company. The sales message is completely lost. In most cases, even if it was remembered, it would be inappropriate or outdated as far as the product's current marketing strategy is concerned. The phrase "What have you done for me lately?" has great meaning when applied to consumers and the advertising messages they receive.

Regardless of the effective life of any single advertisement, almost half of all advertising cannot, by definition, have any impact whatsoever beyond the period when the costs of advertising are incurred. Consider the following examples:

Promotion Advertising - Promotion advertising is specifically designed to generate short-term sales results by offering special purchase incentives to consumers. Therefore, the focus of promotion advertising is on the short-lived incentive, be it "cents off" savings, a refund, a premium or some sort of contest. Such a focus provides little opportunity--nor is it intended--to have any residual "goodwill" effect.

A. C. Nielsen identifies promotion as a means to generate a relatively immediate bump in a product's sales. More important, Nielsen data indicate the promotion results are just that--a bump. Following a promotion event, sales return to their previous level; no measurable residual effect is evident. According to Nielsen, product movement generated by promotions peaks six to eight weeks after the event, further illustrating the short-term nature of such efforts.

Direct Response Advertising - An estimated $30 billion (approximately one quarter of total advertising expenditures in 1985) was spent on Direct Response Advertising conducted through the mail or via telephone. Direct response advertising is short-term advertising where the objective is to elicit an immediate response from consumers. It is not designed to be, nor could it be, effective in generating any long-term residual

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effects. The typical direct response effort achieves 90 percent of its response in four weeks and the remainder in a maximum of eight weeks.

Retail - Retail advertising, the largest catagory of all, is designed to achieve its objective within a short period of time, usually a matter of days. According to the Newspaper Advertising Bureau, retail stores and services spend an average of approximately three percent of sales dollars on this kind of advertising.

Highly Seasonal Products - Some product categories are so seasonal that they advertise only for short periods during the year, their objective being to move as much volume as possible during that time. The fragrance category, for instance, which spends $190 million (1985) on advertising, spends the bulk of its dollars during short periods of high seasonality. Other seasonal categories include agricultural products, toys, seasonal cards (holiday specific), entertainment (shows, movies, books, events), and travel and resorts.

Classified - Classified advertising is what is found in the Yellow Pages, other directories, and in the back of newspapers and magazines. Its objective is to announce the availability of a product or source for a specified period of time, often at a specified short-term rate. The content of classified advertising includes only the bare minimum of factual data, which does not generate any long-term residual effect. The Yellow Pages alone ran $6.8 billion in advertising during 1985. Newspapers report that 29 percent ($7.5 billion in 1985) of their ad revenue is from classified ads.

Political Advertising - Political advertising perfectly demonstrates the short-term impact of advertising. The marketing process of a political campaign is finite; everything about the process is geared to motivate individuals to take a single action on a single day.

Finally, consider test market and new product advertising expenditures. Hundreds of millions of dollars are spent each year on advertising to support new or existing products in test market situations. Payout on these expenditures is figured on what immediate returns are achieved. Almost half of all product tests (47%) fail within one year, therefore the advertising cannot possibly have any lasting impact.

ADVERTISING PLAYS A LARGE ROLE IN FOSTERING COMPETITIVENESS, INNOVATION AND GROWTH IN OUR ECONOMY. PROPOSALS TO DISALLOW OR AMORTIZE A PORTION OF ADVERTISING EXPENSES WOULD DAMPEN ITS EFFECTIVENESS AND THUS HAVE AN ADVERSE EFFECT ON THE ECONOMY.

Proposals to delay or deny deductions for advertising expenses would inevitably slow economic growth and lower the GNP. Changing the tax status of advertising expenses would raise the after-tax cost (price) of advertising resulting in a reduction of advertising volume. This would have a direct negative effect on the economy because revenues would be reduced for advertising agencies, newspapers, periodicals, radio and TV networks and stations, billboard advertising, third class mail advertising, transit advertising and various forms of specialty advertising. These businesses, in turn, would be forced to cut back on their workforce, thereby forcing people into the ranks of the unemployed.

A reduction in advertising would also negatively affect consumer expenditures on goods and services. The role of advertising is not only to help a firm capture a larger share of a given market, but also to increase the size of many markets. Advertising provides information useful to consumers in deciding whether and how to spend their money; it identifies new products or the benefits and attributes of older products.

Advertising can also bolster consumer confidence and lead to increased levels of consumer spending. Advertising, particularly for high-priced items, attempts to convince consumers that the time is right for a purchase. Such advertising identifies favorable credit terms, cash rebates or other benefits for immediate purchase.

Because of the role of advertising in stimulating sales, the multiplier effect would apply in reverse to a reduction in advertising expenditures. Any one-dollar reduction in expenditures would certainly result in a greater-than-one-dollar reduction in sales volume.

The relationships between advertising and the economy have been identified by Wharton Econometrics, the respected econometric consulting firm. Wharton studied the economic impact of two proposals; 1) allowing deductability of only 80% of advertising expenses, and 2) five-year amortization for the remaining 20% of advertising expenses. Under the first scenario limiting deductability to 80%, Wharton Econometrics estimated that the net economic impact within five years would be:

- an initial job loss of 185,100, mounting to more than 506,600 in five years;

- a cumulative loss in output of $76.7 billion 1985 dollars;

- a cumulative loss in real disposable income per household of $522 (1985 dollars).

Under the second scenario whereby 20% of advertising expenses would be amortized over five years, assuming a discount rate of 10%, the net impact within five years would be:

- an initial job loss of 110,800, mounting to more than 184,500 in five years;

- a cumulative loss in output of $33.7 billion 1985 dollars;

- a cumulative loss in real disposable income per household of $309.76 (1985 $).

Proposals to delay or deny deductions for a portion of total advertising expenditures would inadvertently help foreign corporations operating in the U.S., and thereby place U.S. corporations at a competitive disadvantage. Competition between domestic and foreign companies operating in the U.S. is intense. Delaying or denying the deductibility of a portion of advertising expenses would be extremely costly to domestic companies. However, there would be no additional costs to foreign companies operating in the U.S.

Foreign companies, lured to the U.S. because of its favorable tax rate, would be willing to spend more on advertising to get a larger share of the U.S. market. This can be done at no additional cost to the foreign company, since the proposed U.S. tax rate is lower than the rate in most foreign countries. When funds are repatriated, the foreign company would get a foreign tax credit for the full amount of the U.S. tax. Therefore, no additional cost would be incurred.

Delaying or denying the deduction of a portion of advertising expenditures would inhibit the development of new products and the start up of new businesses. New products and new businesses are already high-risk propositions. The large majority of them ultimately fail. Their development is both costly and difficult. Advertising plays an extremely important role in the success or failures of new enterprises. Proposals to delay or deny tax deductability of the advertising expenses of new enterprises would substantially add to start-up costs and make a decision to go forward less likely. This could lead to less competition in the

marketplace, which in turn would result in less innovation. The consumer would ultimately suffer by having fewer choices and by paying higher prices for goods and services.

Proposals to delay or deny tax deductability of advertising expenses would greatly increase the risk of new product and new business failures. Most new products are entries into or extensions of existing categories which already have established leaders. Extensive advertising support for the new product is essential to build awareness rapidly. Consumers must be informed of the benefits of the new products - why they are preferable to the established brands. The consumers' ties to the established brands must be broken. Advertising is an effective way of building the necessary awareness. But it is expensive. For example, new products in the first year typically require a disproportionate share of advertising relative to the desired share of market.

Most still don't make it. According to Nielsen's NEIS Alert, of all new products introduced in grocery stores in 1983 and 1984, only slightly more than 2% were successful:

Year	Introduced New Products	Successful New Products	Success Rate
1983	851	17	2.0%
1984	733	17	2.3%

While increasing the amount at risk, the advertising expense deductability proposals would not change the potential reward. This would logically result in fewer new products being brought to the market and greater reluctance to start new ventures. The proposal would strengthen the position of entrenched products and established businesses. The ultimate loser is the consumer, since there would be less incentive for the development of new or improved or less expensive products and services.

ADVERTISER-SUPPORTED MEDIA WOULD BE HIT EXTREMELY HARD BY ANY CHANGE IN THE STATUS OF ADVERTISING TAX DEDUCTABILITY. THESE PROPOSALS WOULD ULTIMATELY RESULT IN REDUCING THE FLOW OF INFORMATION IN OUR SOCIETY.

Advertising represents the single most important source of financial support for media in the United States. In the case of radio and television, advertising pays almost the entire cost of transmitting news, opinion and entertainment. Newspapers and magazines are able to maintain the price of their publications within the acceptable limits solely because advertising represents such a significant part of the revenue.

Proposals to delay or deny deductability of advertising expenses would greatly impact the revenues of all media operations. This would leave them with few choices. Newspapers and magazines would have to increase the cost to consumers of the information and entertainment they provide. The broadcast media as well as newspapers and magazines would have to look at cost cutting in the form of reduced staffs and decreasing the amount of services provided to consumers.

The long-term impact would be to reduce the flow of information in our society. Newspapers and magazines represent a very important source of information to the American people. Unlike radio and most television programming, these sources of information are not free. If the proposed delay of advertising expenses results in a substantial increase in the cost to the reader, circulation will decrease, and many financially marginal publications will go out of business, leaving fewer sources from which opinions can be formed.

Delay or denial of the deductability of a portion of advertising expenses will most severely impact the small town media outlets. These outlets are often solely dependent on the local business advertising revenue. Local businesses are exactly the businesses that would be most hurt by a delay or denial of the allowable advertising deduction. Being most concerned with the cost of doing business, they would most probably reduce advertising spending on local media by a substantial, if not full, portion of the amount delayed.

TAX LEGISLATION WHICH IS DIRECTED TOWARDS THE SUPPRESSION OF SPEECH ADVOCATING THE USE OF SPECIFIC LEGAL PRODUCTS (i.e., ALCOHOL, TOBACCO) WOULD DIRECTLY VIOLATE THE FIRST AMENDMENT RIGHTS OF THE AFFECTED INDUSTRIES.

The Government is proscribed by the Constitution from curtailing the public's access to information. Legislation that would deny the deductability of advertising expenses for one disfavored industry while maintaining deductability for others clearly places the speech of that industry on a different footing from its corporate partners. This would represent a clear case of governmental interference with the industry's exercise of free commercial speech.

Allowing tax deductions for the advertising expenses of products such as alcohol and tobacco does not imply governmental endorsement of these products, nor does it represent a governmental subsidy for these industries. Our tax system is based on the premise that only net income is taxable with deductions permitted for all costs reasonably incurred in producing that income. If the federal government were to disallow normal business deductions for one industry of which it disapproved, it could selectively tax any individual or group who disagreed with any government policy, thus, seriously threatening the First Amendment.

Mr. STARK. Thank you, Mr. O'Toole. Mr. Helm, who is president of the Association of National Advertisers will conclude the panel's testimony.

STATEMENT OF DeWITT F. HELM, JR., PRESIDENT, ASSOCIATION OF NATIONAL ADVERTISERS, INC.

Mr. HELM. Mr. Chairman and members of the committee, until I joined the Association of National Advertisers almost 4 years ago, I had spent my entire business career in various responsibilities managing advertising while employed by three national advertisers. Experience in the trenches gives me genuine concern about the advertising proposals before your committee and the effect they would have both on the economy of our country and the welfare of the 300 companies with over 2,000 subsidiaries and divisions that ANA represents.

The full tax deductibility of advertising expenses provides enormous benefits to our Nation. Advertising is the engine that drives our Nation's economy. It is the most efficient means of selling ever devised. Disallowing or postponing the deductibility of a portion of advertising expenses would penalize advertisers for selling efficiently and make advertising a far less effective means of selling. Legislation to disallow or limit the tax deductibility of advertising will severely hurt economic growth and job creation in the United States.

Common sense suggests that increases in prices will depress sales, while less advertising will produce lower sales volume. But we do not have to rely on common sense alone. In 1986 Wharton Econometrics predicted a loss of tens of thousands of jobs and billions of dollars to the economy if advertising were made more expensive.

We have heard about the severe impact of these proposals on the media. Small businesses also will be severely hurt. While they may only be spending a limited number of dollars on advertising, these dollars could be the difference between success and failure.

These tax proposals will particularly impact companies, whatever their size, that are launching new products or breaking into new markets. These companies will find themselves competing against companies that developed their market shares when they could immediately deduct 100 percent of their advertising expenditures.

The vast majority of all advertising is directed to sales of particular products or services to a very limited time frame. For example, classified advertising and newspaper advertising for supermarkets. To allow a small number of advertisements that theoretically may have an impact in more than 1 year to create a precedent for all advertising is clearly inappropriate.

No one knows whether a new advertising campaign will be successful or how long the effects of advertising will last. How should we amortize the infamous campaign for the Edsel automobile?

According to the A.C. Nielson Co., most new products fail. Of 733 new items introduced in grocery stores in 1984, only 17—or 2.3 percent—were successful. Does it make sense to defer advertising costs for products that failed in the marketplace? With strong odds

against success, should we place an additional tax burden on launching new products?

Moreover, the word advertising is not a term of art. It does not have any fixed and agreed upon definition. These tax proposals, thus, would create an administrative quagmire for both government and advertisers.

Critics of advertising suggest that advertising be singled out for adverse treatment because other business expenses, such as R&D, are more vital to the Nation's economy.

While it is claimed that if you build a better mousetrap the world will beat a path to your door, many companies have found out that whatever improvements R&D accomplishes are obviated if information is not brought to the attention of the public through advertising. Trying to sell a product without advertising is like winking at the opposite sex in the dark. You know what you are doing, but nobody else does.

ANA believes the more a company advertises or is dependent on advertising, the more these tax proposals will be detrimental. But some quarters suggest that the ability to write off advertising as a business expense disadvantages companies whose investments are primarily directed to the deployment of tangible assets, the cost of which must be depreciated or amortized.

This point of view overlooks the fact that companies that develop steel, paper, chemical and other key components of consumer products would not be able to sell them to industry if advertising did not generate consumer demand.

Also pending before this committee are proposals to totally disallow the tax deductibility of advertising of tobacco and alcohol products. ANA strongly opposes any limitation on, or total disallowance of, the tax deductibility of advertising for any product or any service by singling it out for adverse tax treatment.

Making advertising for particular products inordinately expensive by eliminating advertising expense deductions may appear to be a less direct approach towards censorship and intrusion on congressional rights than an outright ban, but it is no less damaging to the first amendment and ANA strongly urges the House Ways and Means Committee to reject these proposals.

In conclusion, ANA strongly urges retention of the full and immediate deductibility of advertising expenses. Alteration of these business deductions will significantly increase the cost of selling products and services and severely damage our nation's economy.

Thank you for your time and your attention.

[The statement of Mr. Helm follows:]

Statement of
DeWitt F. Helm, Jr.
President
Association of National Advertisers, Inc.

The Association of National Advertisers, Inc. (A.N.A.) strongly urges that the Congress retain the full and immediate deductibility of advertising expenses. Alteration of the existing business deduction provision in the advertising area will significantly increase the cost of selling products or services, increase the cost of goods, and severely damage the economy.

A.N.A. is deeply concerned about this issue as we represent almost 300 companies, with over 2,000 subsidiaries and divisions, (many of which are relatively independent advertiser entities), located throughout the United States. Our members sell a wide range of products and services and employ advertising as an important element of their marketing and public relations programs. A.N.A.'s members collectively account for over two thirds of all national and regional advertising expenditures in the United States. Although A.N.A.'s membership includes many of the nation's largest advertisers, it also comprises a large number of smaller companies. Approximately one third of A.N.A.'s members, for example, spend under 5 million dollars annually for advertising.

The Internal Revenue Code recognizes that taxpayers should be permitted to deduct ordinary and necessary expenses incurred while carrying on a business, trade or profession. Advertising for a large proportion of American business is one of the most important business expenditures as advertising generates the sales that lead to corporate profitability.

The full tax deductibility of advertising expenses provides enormous benefits to our nation's economy. Advertising is a powerful engine of economic growth. It is the most efficient means of selling ever devised. If the federal government were to disallow or postpone the deductibility of a portion of advertising expenses, it would be penalizing the advertiser for trying to sell efficiently and thus make advertising a far less effective means of selling.

Any legislation to disallow or limit the tax deductibility of advertising will severely hurt economic growth and job creation in the United States. These advertising deductibility proposals will make advertising significantly more expensive. In response companies are likely to follow one of three strategies:

1. Decrease expenditures for advertising;

2. Increase the cost of their products to compensate for the increased selling expense; or

3. Shift expenditures, where possible, from advertising to other areas that will continue to be fully tax deductible. Although advertising, all things held equal, is the most efficient selling method, less efficient methods will become more attractive if advertising is made artificially expensive due to the tax code.

Strategies to decrease advertising expenditures or impose higher product costs or shift business expenditures to less efficient forms of selling in the aggregate are likely to effect detrimentally economic growth, adversely impact employment and lower GNP.

Common sense suggests that increases in price will depress sales while less advertising will result in a lower volume of sales. But we do not have to depend merely on common sense. A study completed by Wharton Ecomometrics Forecasting Associates in June, 1986 carefully evaluated the impact of either disallowing the deduction of 20% of all advertising expenses or requiring the capitalization of 20% of these advertising expenses over five years.

While the advertising tax proposals presently before your committee are not identical to the ones originally studied, they are sufficiently similar to

provide a useful comparison. Both proposals would make advertising significantly more expensive. The original Wharton Study revealed that in the first year alone between 110,000 to 126,000 jobs would be lost. GNP output losses would be approximately 8 billion dollars and the average household income loss the first year would be approximately $65.00. Obviously, the total disallowance of the tax deductibility of 20% of advertising expenses would drastically increase these adverse impacts. The Wharton Study was carried out under the sponsorship of the A.N.A., the American Association of Advertising Agencies and the American Advertising Federation, and I would like to request that this important study be made a part of the hearing record.

Now what would be some of the specific impacts of the advertising deferral or disallowance proposal? Media would be particularly hard hit by these proposals. Most of the media rely extremely heavily on advertising as a foundation for their economic well being. Some media, in fact, depend totally on advertising for their existence. Advertising in 1984, for example, paid for an average of 74% of newspaper revenues, 51% of the revenues of magazines and virtually 100% of of the revenues of broadcast media. Clearly, the deferral proposal will diminish the amount of advertising that will support these various media.

Small business also will be severely hurt by these counterproductive tax proposals. While small business may only be spending a limited number of dollars on advertising, these dollars may be the difference between success and failure. As Mark Twain once wrote to one of his newspaper readers who complained that he had found a spider trapped inside his morning paper, "The spider was examining the newspaper to find out which store is not advertising and then it will go spin its web across their door and live peacefully ever after."

Wharton Econometrics Forcasting Associates, Inc. specifically analyzed the issue of limiting advertising deductions as it impacts small business. Wharton concluded:

> "The impact of limiting the deductibility ofadvertising expenses should have a larger negative impact on small business than on large business...Many new small business firms enter existing markets with the help of advertising. By limiting the deductibility of advertising, it will make it more expensive for new small businesses to obtain a sufficient market share. These higher costs of entering markets will discourage the creation of new business and inhibit competition."

In fact, the advertising tax deductibility limitation proposal will fall particularly heavily on companies --whatever their size-- that are attempting to bring out new products or break into new markets. These companies furthermore will find themselves competing against companies that developed their market shares at a time when they could immediately deduct 100% of their advertising expenses. Placing a burden on advertising, a key tool of economic competition, clearly is counterproductive.

Proponents of the advertising tax deferral proposal may argue that since some advertising provides benefits for longer than one year, such costs should not be permitted to be taken fully in the year incurred. Unfortunately, while this argument initially may sound attractive, closer examination demonstrates that such an approach would be administratively unworkable and economically damaging.

Most advertising is directed to the sale of a particular product or service in a very limited time frame. For example, supermarket advertising in

newspapers for food specials, national TV seasonal and holiday promotions, buyer incentive programs, and classified advertising for real estate, job openings and a multitude of other goods and services all serve to fill the advertising space of our national and local media. To allow a small number of advertisments that theoretically may have an impact in more than one year to create a precedent for all other advertising is clearly unfair and inappropriate.

Furthermore, no one knows whether a new advertising campaign will be successful or how long the effects of the advertising will last. Yet, this proposal totally ignores the fact that most new product introductions fail in the marketplace. How should we capitalize for tax purposes the famous campaign for the Edsel automobile?

In fact, according to the Nielson Early Intelligence System 1984 Product Success Study, failure of new product launches is the norm and success is the exception. Of 733 new items introduced in grocery stores in 1984, only 17 (2.3%) were successes (a successful product was defined as achieving a total annual value of 15 million dollars). Does it make sense to defer the advertising cost for product lines that have failed in the marketplace and have been totally discontinued? The answer is obvious. In light of the already strong odds against success, should we place a further heavy tax burden on the process of launching new products. Again, the answer should be clear.

Also, if we single out the business expense of advertising arbitrarily for special and adverse treatment in the tax code, we will be creating, without anyone admitting it, extremely broad precedents. Many of the ordinary and necessary costs under section 162 of the Internal Revenue Code have the theoretical potential of providing benefits for longer than one year. Examples of such expenditures include the cost of training employees, research and development expenses, and the staff and operation of corporate public relations and legal departments. Once we start down the road of trying to squeeze out revenues by amortizing, capitalizing or totally disallowing deduction for costs related to activities that might have an impact in more than one year, the group of expenses affected is substantial.

The advertising tax deductibility disallowance or deferral proposals, if passed, also will create severe administrative difficulties for the government. The word "advertising" is not a term or art; it does not have any fixed and agreed upon meaning. Even the most experienced practitioners in the field often disagree as to what should be considered to be advertising and what should be excluded. The Department of the Treasury, through the Internal Revenue Service, however, will be forced to make such a determination. How will this determination be made to assure a fair and equitable tax policy?

Will direct mail be considered advertising? Signs in retail stores? Decorated shipping containers which protect the product, but are also used for display purposes? Should brand or company logos on trucks, tee shirts or other wearing apparel be treated as advertising? Should advertising be separated from other related activities such as "public relations" and "promotion"? These examples, of course, could be multiplied many times. Developing workable concepts will be complex, time consuming, and assure high compliance costs. But, this highly technical effort still cannot avoid significantly hampering the selling process.

Critics of advertising also have suggested that advertising should be singled out for adverse tax treatment because other business expenses, in their view, such as research and development, are somehow more vital to the nation's economy. It is suggested that advertising is somehow frivolous in comparison to these supposedly more important functions. But this view totally ignores

the role advertising plays in our economy. It often has been claimed, for example, that if you build "a better mouse trap the world will beat a path to your door." However, many companies have found that whatever improvements their research and development programs accomplish often are obviated if they do not effectively bring this information to the attention of the public through advertising. As one commentator has noted, "trying to sell a product without advertising is like winking at a woman in the dark; you know what you are doing but nobody else does."

A.N.A. believes it is obvious that the more a company advertises or is dependant on advertising for its selling effort, the more the tax deductibility proposals will hurt them. In some quarters, however, this argument has been turned on its head to suggest that the ability to write off advertising as a business expense disadvantages companies whose investments, in the words of the House Ways and Means staff tax options paper, are primarily directed to the development of "tangible assets" or other assets "the cost of which must be depreciated or amortized."

This point of view, unfortunately, completely overlooks the fact that companies that develop the iron, steel, paper and other key components of our consumer products would not be able to sell them if advertising did not generate and help to maintain the consumer demand that creates the sales volume necessary to create the need for these inputs. Any policy that weakens the selling process thus not only hurts major advertisers, but all other advertisers that are dependent for their success on supplying these major advertisers with goods and services.

While ostensibly these advertising tax proposals are only to last for a limited time period, we in the advertising community are concerned that this approach will create precedents for requiring advertisers to carry a disproportionate and counterproductive tax burden every time the government needs to find new revenue sources. Close examination of the tax code will provide numerous examples of taxes that were initially launched on a limited basis and supposedly for a limited duration that now apparently have taken on a permanent life of their own.

Also pending before your committee are proposals to totally disallow the tax deductibility of the advertising of tobacco and alcohol products. A.N.A. strongly opposes any limitation on, or total disallowance of the tax deductibility of advertising of products that are singled out for adverse tax treatment.

It is well established that advertising is protected by the First Amendment. Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council 425 U.S. 748 (1976); Central Hudson Gas & Electric Co. v. Public Service Comm'm, 447 U.S. 557 (1980).

The landmark case of New York Times Company v. Sullivan, 376 U.S. 254 (1964), involved statements in an advertisement which gave the Supreme Court an opportunity to describe the critical role that advertising plays in social debate. Advertisements the Court said are "an important outlet for the promulagation of information and ideas by persons who do not themselves have access to publishing facilities who wish to exercise their freedom of speech even though they are not members of the press." Proposals to single out for adverse treatment the tax deductibility of alcohol or tobacco or any other product that certain members of the Congress do not like is unconstitutional.

The United States Supreme Court repeatedly has stated that discriminatory taxation of speech is unconstitutional. "It is seen to be a deliberate and calculated device in the guise of a tax to limit the circulation of information." Grosjean v. American Press Company, 297 U.S. 233 (1936). The United States Supreme Court in Speiser v. Randall, 357 U.S. 513, 518 (1958) recognized that "speech can be effectively limited by the exercise of the taxing power." The Court in that case emphasized that "It cannot be gainsaid

that a discriminatory denial of a tax exemption for engaging in speech is a limitation of free speech." Id. at 518

The United States Supreme Court has made clear that the First Amendment forbids the use of discriminatory tax treatment for the suppression of disfavored commercial speech. When the Court has upheld denials of tax exemptions in connection with speech-related activity, it always has stressed that the restrictions could not have survived scrutiny if they had favored some speech over other speech on the basis of its content, e.g. Regan v. Taxation with Representation, 461 U.S. 540, 548 (1983); Cammarano v. United States, 358 U.S. 498, 513 (1959).

In Arkansas Writers Project Inc. v. Arkansas, 55 U.S. L.W. 4522, the U.S. Supreme Court just this April stressed that "above all else, the First Amendment means that government has no power to restrict expression because of its message, its ideas, its subject matter or its content...Regulations which permit the government to discriminate on the basis of the content of the message cannot be tolerated under the First Amendment." Id at 4524

Even Chief Justice Rehnquist and Justice Scalia who dissented in the Arkansas Writers Project case stressed that denial of participation in a system of tax exemptions would infringe the First Amendment if the denial were intended to produce, or did produce, "a significant coercive effect" --that is an inhibition of speech. Eliminating the advertising expense deduction for particular products would have just such an effect.

In introducing legislation to ban the tax deductibility of alcohol and tobacco products, an attempt has been made to mask this coercive purpose. The proponents of this legislation state that they are merely ending a government "subsidy" for products they consider harmful. But the advertising expense deduction is no more a "subsidy" than the payroll expense deduction. Under our tax system, the government taxes only net income -- not costs reasonably incurred in producing income. The advertising expense deduction simply applies this principle.

Even assuming, for the purposes of argument, that advertising expense deductions are a government subsidy, Congress still could not constitutionally allocate such deductions soley to businesses whose speech the government approved. Thus, it is well established that government may not discriminatorily restrict expression in public places such as streets, public libraries, and universities. These "public forums" were created and continue to exist because of government "subsidies."

The Postal Access Cases affirm this principle. In those cases the Supreme Court has repeatedly held that use of the Postal System may not be constitutionally limited to mail containing information which the government approves. U.S. Postal Service v. Council of Greenburgh Civic Association, 453 U.S. 114, 141-42 (1981); Bolger v. Young's Drug Products Corp., 463 U.S. at 80; United States v. Van Leeuwen, 397 U.S. 249, 251-52 (1970).

Making advertising for particular products inordinately expensive by eliminating the advertising expense deduction may appear to be a less direct approach than an outright ban, but it is no less damaging to the First Amendment. A.N.A. strongly urges the House Ways and Means Committee to reject these proposals. As Eugene C. Thomas, President of the American Bar Association, has stated, "There's a serious legal problem to the use of the tax code for social engineering." Once we start down this road, we will move quickly beyond tobacco and alcohol products to many other categories of advertising.

Censorship is contagious even when it is hidden under the guise of tax policy.

In conclusion, advertisers support a fair, administratively efficient and economically sound tax system. Unfortunately, the advertising tax deduction proposals pending before the Congress fail these tests.

Banning or restricting the business deductibility of advertising will initially hurt advertisers; but quickly as the selling process is burdened and made more expensive, these adverse affects will ripple through the economy. Advertising agencies, the media, and companies that supply goods and services to advertisers will be damaged. Finally the public and the economy as a whole will be injured. Trying to limit the tax deductibility of advertising will create a regulatory quagmire -- while trying to single out certain categories of advertisers for disadvantageous tax treatment is unconstitutional. Let advertising do its job. Let us not burden the selling process. Let advertising drive the economic engine that creates jobs, sales and corporate profits that, of course, are taxed.

Thank you. We would be pleased to answer any questions you may have.

Mr. STARK. Thank you, gentlemen. Mr. Lynn, does the ACLU feel that banning tobacco ads just across the board would be also a violation of the first amendment?

Mr. LYNN. Yes, we do, and we have so testified on several occasions before the Energy and Commerce Committee.

Mr. STARK. There are several—I am not a lawyer, so I do not know all the answers to your questions—but, you are familiar with Melvin Wulf who used to be the legal director of the ACLU, and who said in the Washington Post a year ago,

> Presumably, my former colleagues at the ACLU together with the Tobacco Institute and the advertising industry will declare that prohibition of tobacco advertising will be followed immediately by the end of the first amendment as we know it. Do not believe it. The only result will be a reduction in tobacco consumption, heart disease and cancer. Our real first amendment freedoms will be as intact as ever.

You are familiar with his arguments?

Mr. LYNN. I am, and certainly within the ACLU there is a great difference of opinion about many things including this issue, but I think Mr. Wulf is wrong on the merits and wrong on the constitutional law.

Mr. STARK. You do not mention the *Posadas* case. That you do not feel has any bearing on this issue?

Mr. LYNN. I mentioned that it was essentially a case that reaffirmed the basic construct in the *Central Hudson* case. *Posadas* is a case that involves a time, place and manner restriction on advertising, and in my judgment, is not applicable to an outright ban on advertising.

Mr. STARK. But you are aware that there are many who disagree with you, including the Congressional Research Service, American Law Division, who tells us that H.R. 3950 would be constitutional.

Mr. LYNN. I have read it and in other places have criticized it, and I believe there is a great difference of opinion about the significance of the *Posadas* case in the context of tax deductibility or an outright ban.

Mr. STARK. Is it your opinion that outlawing billboards as they did in San Diego is a violation of the first amendment? The reason there was to keep the city of San Diego more beautiful, and it was upheld by the Supreme Court.

Mr. LYNN. That is true, but of course, it was not a content specific set of advertisements on the billboards that were at issue and I think that is a major difference.

Mr. STARK. So you have got no quarrel with that? You could eliminate all billboards because they are ugly, and that is not a first amendment right.

Mr. LYNN. No, I said earlier that there was an issue raised about whether it would make sense constitutionally to reduce or to eliminate all of the tax deductibility of advertising because consumers would then have less information.

Mr. STARK. I am just asking you about the billboard case. You have got no quarrel with that as a first amendment violation, right?

Mr. LYNN. I would not say I have no criticism of it, but it certainly is very different from what is up here.

Mr. STARK. But not enough to file a case.

Mr. LYNN. Excuse me?

Mr. STARK. Not enough to appear on behalf of the billboard companies?

Mr. LYNN. I will find for the record whether we were a participant in that case. I believe we were, and that is why I am a little reluctant to say we are enthusiastic supporters of it.

Mr. STARK. Now we do not allow tobacco to be advertised on the radio, right?

Mr. LYNN. That is correct.

Mr. STARK. And on television.

Mr. LYNN. That is correct.

Mr. STARK. Is that a first amendment violation?

Mr. LYNN. I think that it is.

Mr. STARK. Have you done anything about that? Have you filed a lawsuit?

Mr. LYNN. As a matter of fact, at the time that that was an issue, the policy of the American Civil Liberties Union on commercial speech was unclear, and in fact, we were not a participant in that debate, to the best of my research.

Mr. STARK. Are you going to challenge that one?

Mr. LYNN. I think the time has passed to challenge that in any realistic way.

Mr. STARK. If my bill prevails, will you challenge it? Will you take it to the Supreme Court?

Mr. LYNN. I think there is no question that if your bill prevails we would be a party to a challenge to that.

Mr. STARK. If one of the bills was going to prevail, which would you rather see? Which is the less evil, banning the exemption of the tax deduction or just banning the advertising?

Mr. LYNN. I do not, frankly, think I can answer that question. I think one assault on the first amendment is as bad as another. And although it is possible that Mr. Wulf is correct when he says the first amendment will not collapse if either of those things happen, when you start to eat away at the edges, finally the whole center of the first amendment is gone and no one has even noticed it. So I am very reluctant to give you a flat answer to that question.

Mr. STARK. Okay. Now you are aware that tobacco products kill more than 300,000 people each year, are you not?

Mr. LYNN. Well, there is certainly strong evidence that they contribute to the death of many people.

Mr. STARK. And that smoking accounting for 130,000 lung cancers deaths in 1984 alone. Are you aware of that?

Mr. LYNN. I have heard large numbers but I am no public health expert and do not claim to be.

Mr. STARK. Okay. And have you heard that smoking is implicated in 30 percent of all cancers?

Mr. LYNN. I have heard that number.

Mr. STARK. And have you heard that the cost of medical care—just the medical care alone—for smoking related disease amounts to about $21 billion a year?

Mr. LYNN. I have heard that number as well. But again, those numbers do not tell the whole story because one has to assess the impact of——

Mr. STARK. I understand that, because there are also smoking related costs paid for by Medicare and Medicaid of $5 billion a year, and that we can prove.

Mr. LYNN. I have heard that number.

Mr. STARK. I could give you the bills. I could send them to the ACLU along with my renewal for membership, but that is going to be a tougher check to write, I must say.

Would you not say that if all those number are, in fact true, that the Federal Government has a substantial interest in protecting the health of American citizens?

Mr. LYNN. Well, it certainly has a substantial interest in protecting health. But it also has a substantial interest in protecting a number of other values, including the guarantees of the first amendment and the right of Americans to choose to do even those things which they might find risky.

Mr. STARK. All I remember, as a kid who never went to law school, is you do not have a right to holler "fire" in a theater.

Mr. LYNN. In a crowded theater, unless there is a fire. But I think this is quite different because what we are talking about here are people—you know, you would have to have lived in a cave for the last two decades not to know of some of those numbers, or to know of the implications that smoking in the view of many people is dangerous.

But I see no benefit to this society of removing from the place of public discourse all of the speech of one element, that is, those who would promote or advertise the availability of a lawful product called tobacco.

Mr. STARK. And you do not think that deductions are a subsidy?

Mr. LYNN. I do not believe that they are for constitutional purposes. And I think that to subsume everything as a subsidy really is to subsume the whole Tax Code into something like a subsidy, and I think that clearly is not the case.

Mr. STARK. I do not think you would get much argument on this committee, the whole Tax Code is a complicated subsidy. I mean, the original tax was just a percentage that you multiplied. Everything beyond that is, in fact, a subsidy.

Mr. LYNN. I think though that to characterize it as a subsidy in the context in which you and a number of other members of this committee have done so, is to divert attention from the final result of this proposal——

Mr. STARK. I would not be disingenuous. The only reason that we work on the deductibility is to get jurisdiction. I mean, there is no quarrel. I would do it, if I could figure how to get it, in the Veteran's Committee or any other place.

I am on the District of Columbia Committee. If I could figure out how to do it in the District of Columbia. I do not mean to try and hide anything. I would like to ban cigarette advertising. It is an evil. And actually, I used to teach advertising in one of the what is probably now less prominent business schools, if I mentioned it. So I have got no quarrel with advertising.

My quarrel is just the fact that cigarettes kill people in huge numbers and cost us billions of dollars, and that advertising hooks kids. It convinces kids that they are going to be better athletes,

better sexual performers, better looking, have clearer complexions, all that, which you and I know is not true.

Mr. LYNN. Now, Mr. Stark, we all know that, but we also know that nobody advertises a product as if it is going to make the user of that product into an ugly person that no one would date unless they wore a bag over their head. That advertising has as its purpose the sending of a signal that something is useful.

Mr. STARK. I guess that it would be interesting. As I say, as an observer, I hope that my bill passes and the ACLU sues whoever they sue, and it goes to the Supreme Court and then we will see what happens. It will be interesting. And I assure you I have no quarrel with the ACLU and certainly not with the first amendment and certainly not with the advertising industry.

The quarrel just lies with the question of whether or not we should—let me put it another way. That we should not discourage in every possible way. And we have done some of that by banning tobacco ads, and I guess liquor ads from the electronic—we cannot advertise liquor or wine on electronic, can we, anymore? Is that right?

Mr. FRITTS. You are allowed to do it, but broadcasters voluntarily do not advertise hard liquor. We advertise beer and wine.

Mr. STARK. Beer and wine, but not tobacco? Tobacco by law?

Mr. FRITTS. Tobacco by law.

Mr. STARK. And I am sympathetic. But the billboard thing, I guess is a legal—I would rather see the billboards, as ugly as they are, than I would the cigarette advertising. But I think that—and I can understand the advertising industry's feeling that this is just the first step, the domino theory. But that does not—I do not think there has ever been much discussion about other particular products.

Mr. LYNN. There certainly has been about alcohol. And in fact, this whole issue of banning——

Mr. STARK. Warning labels are coming up for alcohol, I gather. And someday—I mean, I guess if you could prove as conclusively as they have now proven, the direct cause and effect. I mean, if you could say, alcohol kills you. Not that you have to get a snoot full of it and then get behind the wheel of a car, or that you have got to drink too much of it every day so you get cirrhosis.

But I mean, smoke a little bit every day or sit next to somebody who does every day, you are going to get lung cancer, or heart disease or something else. I am not sure that they are that direct with alcohol.

But there are enough other things to advertise so that advertising agencies can make a fortune, I would think.

And the ACLU can go on and take on—Mr. Califano had a good example the other day when I said something about his work at Chrysler and the Medicare system and I criticized what they were doing. And he said—and I think this must apply to the ACLU on this case—that the difference between a liberal and a cannibal is that the cannibal only eats his enemies.

Having said that, I would recognize Mr. Guarini.

Mr. GUARINI. I want to congratulate you on doing a good job and making us a consumer nation. What has happened is that we have a very low rate of capital formation because the advertising agen-

cies in America have really gotten us to be consumer minded in purchasing everything we can purchase and not save the kind of monies we need for industrial expansion. But that is a congratulatory note because you are true professionals and we do better in this country advertising probably than any other country in the world.

What the thrust of your testimony is that what is good for advertising is good for America. What I would like to ask of you is what stand you take on the budget deficit, as to A, do we need to raise taxes? B, should it be progressive? And C, what kind of tax should it be?

I am sure that, other than just defending your industry, you want to come before the committee and give us the benefit of your thinking from your business experience, what is the best way for our committee to go because what the issue is is not necessarily should the tobacco industry pay the health cost that they have created, or alcohol industry in America. That is an issue that will be decided in another arena.

I am wondering where you place us in regard to the kind of attacks that should be set forth. Should there be an excise tax? Should there be a surtax? Should there be an estate tax? Do you have any opinions? Do you want to take a crack at it, Mr. Helm?

Mr. HELM. Mr. Chairman, like my friend John O'Toole, I am not a tax expert and probably anything I would say on that subject, from an inventive standpoint would offend at least 25 percent of my membership.

Having said that, I think the central point I would make is that national advertisers would seriously contend that the process that drives the economy should not be compromised in any way, but rather that the tax burden should somehow be placed on the profits that are generated through commerce.

Mr. GUARINI. Then you are saying we should raise income tax.

Mr. HELM. If I get any more specific than that, I am going to have to write a resume.

Mr. GUARINI. But we should raise income taxes, in your opinion, of the corporations?

Mr. HELM. I would like to leave that to the tax experts. We would like to suggest to you that it would be totally counterproductive to tax advertising because what that is going to do is reduce the tax base and reduce income. It is going to be counterproductive over the longer time.

It is not going to do what this committee is attempting to accomplish. That is the point that we want to make. We are on your side. We cannot tell you how to do it, as far as raising more tax income is concerned, but what we do want to say is please do not, in the process of attempting to do that, shoot both the government and us in the foot.

Mr. GUARINI. Well, do you have any objection to having excise taxes on tobacco and alcohol?

Mr. HELM. I cannot speak for the tobacco companies.

Mr. GUARINI. I do not want to put you on the spot.

Mr. HELM. You do not want me to write a résumé?

Mr. GUARINI. No. I think you have opinions, nonetheless. I understand that you are in a very delicate situation because you do

represent all these industries and all that you can do is come before us and say please do not gore my ox, take it out on the other fellow.

Somewhere along the line, someone has to be responsible for paying for the deficit and for the $19 billion that has to be raised. It has to come from somewhere.

Mr. HELM. Absolutely, and I do not know a single one of our companies that would not pay taxes, in the most appropriate way that you can find that interferes as little as possible with the process by which we do business and stimulate the growth in the economy. But advertising is not that way. It is going to be counterproductive.

Mr. GUARINI. If you are talking about end product, you would be talking about a surtax on income of 5 percent, or whatever sum is——

Mr. HELM. I am going to play Dizzy Dean and slide by everyone of these things, because I make somebody unhappy if I do not.

Mr. GUARINI. You are being a very good diplomat. Anybody have an opinion? Do you want to take a crack at it? Is there any objection to a surtax?

Mr. GOROG. Mr. Guarini, let me respond by first of all agreeing with the fundamental that Mr. O'Toole suggested. That is that we should not be taxing the elements but taxing income and profits. I think my advertisers have cut me off. Excuse me.

Mr. GUARINI. Taxing the income could be an excise tax. It could be an income tax. It could be any other kind of tax, but you do not want a tax against advertising? That is what you are saying?

Mr. GOROG. I think the Congress has accomplished a landmark tax reform act, which has just been put on the books. The key portions of it are based upon simplicity and fairness. I would hate to see us move away from that concept. I would much rather see us move even further into a concept of a flat tax, both on corporations and individuals, where everybody pays their fair share, where the special interests do not have an opportunity to get the subsidies that Mr. Stark was talking about before.

The closer we stay to simplicity and fairness, as far as taxing corporations and taxing business, the better off we are going to be. We do not like to see any single element of the system singled out for taxation purposes and we think it is terribly unfair and terribly unproductive.

Mr. GUARINI. That sounds like a generality, but there are no specifics that you wish to give the committee, so I assume we will just accept your statement that advertising is one way not to go, is that right?

Mr. GOROG. I certainly feel advertising is not the way to go.

Mr. GUARINI. Thank you.

Mr. STARK. Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

Mr. Gorog, I understand that you were a successful businessman before entering government, is that correct?

Mr. GOROG. Yes, I was in business before entering government. I also, Mr. Pease, was born in Trumbull County, Ohio.

Mr. PEASE. Ah, the garden spot of America. In your judgment, is there any difference in the nature of the expense or the benefits

derived from them between the costs of advertising a product and the cost of training your employees to produce or sell the product?

Mr. GOROG. Mr. Pease, I do not see any differentiation whatsoever. In our magazine business, we frequently say that our assets go down in the elevator every evening, because the main assets in the magazine business are the people. You could construe this to say that you need to depreciate an individual from the standpoint of an investment that is made and from a training standpoint.

This can be carried through almost any portion of the manufacturing process and I agree with your statement.

Mr. PEASE. Thank you very much.

Mr. Chairman, I do not have any more specific questions. I would just like to thank the panel and agree with the panel in the points that they have made. Advertising presents an attractive target in some respects, in that it is not tangible in the way that raw materials are or machinery is or even employees are.

But I would submit that advertising in today's economy is every bit as much of an asset as any of the others, and that there is no real basis for singling out advertising for different treatment from any other element of a corporation's business.

I quite agree with the chairman of this committee that cigarette smoking is dangerous and bad and expensive and harmful. I quite agree that a lot of advertising for cigarette smoking is really pretty sophomoric. But at the same time, I have to agree with the ACLU, that there is a first amendment issue here and that as much as we might dislike cigarette smoking from a variety of viewpoints, I do not think as long as we have the first amendment, that we ought to choose in this 200th year of the existence of the Constitution, to pass a provision which in my view would directly violate the first amendment to the Constitution.

For that reason, I do oppose this provision or any provision which would have any relation at all to advertising, whether a general one or a specific product.

I again thank the panel for its testimony.

Mr. STARK. I want to thank the panel and announce the committee will adjourn until 9:30 tomorrow morning.

[Whereupon, at 4:15 p.m., the committee adjourned to reconvene at 9:30 a.m. on Wednesday, July 8, 1987.]

REVENUE INCREASE OPTIONS

WEDNESDAY, JULY 8, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., in room 1100, Longworth House Office Building, Hon. Fortney Pete Stark presiding.

Mr. STARK. The Ways and Means Committee will continue its hearings on revenue increase options.

Word from Chicago is that the chairman rested comfortably during the evening and is continuing to recover.

The first panel I'd like to welcome, and on behalf of the chairman thank them again for their assistance during the Tax Reform Act of 1986 and express the hope of the committee that they haven't changed their minds.

Mr. John Richman, chairman and chief executive officer of Kraft, Inc.; Mr. Finn Caspersen, chairman and chief executive officer of the Beneficial Corp.; and Mr. Allen F. Jacobson, chairman and chief executive officer of the 3M Co.—Minnesota Mining & Manufacturing. Welcome to the committee, gentlemen. Without objection your prepared testimony will appear in the record in its entirety, and please feel free to summarize or expand on your testimony in any manner you're comfortable. We'll start with Mr. Richman.

STATEMENT OF JOHN M. RICHMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, KRAFT, INC., ALSO ON BEHALF OF THE CEO TAX GROUP

Mr. RICHMAN. Mr. Chairman, members of the Committee on Ways and Means thank you. I'm John Richman, chairman of the board and chief executive officer of Kraft, Inc., on whose behalf I am testifying. I also am testifying on behalf of the CEO Tax Group, a group of corporations that very strongly supported and still supports the income tax reforms enacted last year—and especially the lower tax rates under that law.

I have brought with me a statement by the CEO Tax Group opposing change in the tax reform rate structure, and with your permission I'd like to have that statement included in the record.

Mr. STARK. Without objection, it will appear in the record.

Mr. RICHMAN. I might also add that I am an officer and director of the Grocery Manufacturers of America and that my statement is consistent with GMA policy.

Mr. Chairman, over the course of the tax reform debate in 1985 and 1986, we were strong supporters of the tax reform effort. As I said in testimony before this committee in 1985, and I quote, "only by removing numerous special interest provisions can we approach a more neutral, fairer, and simpler tax system. This would permit lower tax rates for individuals and corporations without a revenue loss."

Well, Mr. Chairman, we have our fairer, more neutral system, and we've achieved simplification in some areas. Now it's being suggested that deficit reduction should be achieved in part by attacking the cornerstone of that system—the phased-in rate structure.

Various options have been suggested, among them corporate and/or individual rate freezes, imposition of corporate and/or individual surtaxes, creation of a third rate bracket for high-income individuals.

For the same basic reasons we vigorously supported tax reform, we strongly oppose any of these proposals. We believe that opening up the rate structure for deficit reduction will set a precedent for all believers in preferences that were done away with last year to come in and ask that their tax breaks be restored. Reform of our Nation's tax system has been achieved. It should not now be lost before the Nation can enjoy its benefits.

Mr. Chairman, the same valid arguments that we made in support of tax reform are just as strong today. Reducing rates, coupled with eliminating tax preference items, has produced a more level playing field. Before the enactment of the tax reform law, some very profitable corporations were paying little or no taxes while other, less profitable corporations were paying very close to the top corporate rate.

With the enactment of the Tax Reform Act of 1986, that disparity has been reduced so that more corporations with the same income pay about the same amount of tax.

Before the enactment of the Tax Reform Act of 1986, corporate and individual investment decisions often were based primarily on tax consequences rather than economic merit.

Since the enactment of the act, one frequently reads stories appearing in the national news media about uneconomic tax-driven investments that are no longer being made because of the new tax law. Businessmen are rediscovering the art of making business decisions for business reasons rather than for tax reasons.

The CEO Tax Group was an early and consistent supporter of tax reform. One primary attraction of tax reform for our group was Treasury I's proposed deduction for 50 percent of dividends paid. This proposal was later modified to a 10-percent deduction for dividends paid. The CEO Tax Group nonetheless continued their support for tax reform. The proposal for dividend deductibility was finally dropped. Still the CEO Tax Group supported tax reform, as we do today.

Our group also supported tax reform while faced with the specter of higher taxes in the short-term for a number of its members. The CEO Tax Group supported tax reform despite the inevitability of a large shift of the tax burden from individuals to corporations. And when the final product was hammered out—and $120 billion in tax

burden was shifted from individuals to corporations—the CEO Tax Group supported tax reform.

Our group believes that the Congress and the administration made a compact with the U.S. taxpayers—both individuals and corporations that if taxpayers would give up many of their tax preferences, they would receive lower tax rates in return. We've given up most of our preferences, Mr. Chairman, but the low rates that we traded for them are not effective yet.

Tax reform would not have been possible without a substantial reduction in the tax rates on individuals and corporations. Indeed, the attraction of low rates was the primary driving force behind the tax revision effort.

Low rates led Representative Dick Gephardt and Senator Bill Bradley to craft their Fair Tax package in 1982.

Low rates and a healthy political respect for the ideas represented by the Bradley-Gephardt Fair Tax led to President Reagan's instructions to the Treasury in his 1984 State of the Union Message when he asked for the Treasury to develop a package for fairness, growth, and simplification.

The promise of low rates successfully helped to lead this committee in writing tax reform legislation in 1985.

Low rates revitalized tax reform when it was dead in the water in the Senate Finance Committee in 1986, and low rates helped the conferees withstand innumerable pressures to achieve finally the truly remarkable Tax Reform Act of 1986.

On the other side of the coin, Mr. Chairman, the tax reform debate led to an examination of almost all of the preference items in the income Tax Code. Some preference items—such as the home mortgage interest deduction—were ruled "off the table" early in the process for political reasons. Later in the game, proposals such as denying deductions for excise taxes paid were ruled out for tax policy reasons.

We believe preference items considered during the debate—both those that were dropped and those that were included in the final conference agreement—should not be reconsidered in the current debate over deficit reduction. Such proposals underwent lengthy scrutiny over the past two years, and sound reasons for their inclusion or exclusion in current law became apparent during the course of that debate.

But in particular, Mr. Chairman, we urge this committee to leave the phased-in rate structure alone so that its economic effects may be felt, and individuals and the business community can assess its impact. Many corporations—because of the way their fiscal years are set up—have yet to feel the first reduction in the top marginal rate for corporations. And individuals across the Nation have yet to feel the full effect of their substantially reduced rates, although they have given up many of their preferences.

Mr. Chairman, there have been four major tax bills over the last 6 years, and several other bills that would be counted as major were it not for the great breadth of the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, and the landmark Tax Reform Act of 1986.

Chairman Rostenkowski recently suggested that it's time for this committee and Congress to give the Tax Code a rest and hang a "gone fishing" sign on the committee room door. The reforms enacted in the Tax Reform Act of 1986 are etched in concrete, but the concrete needs more time to set so that the effects of the reforms may be fully assessed and so that taxpayers—businesses and individuals alike—can come to feel that the Tax Code is a relatively stable part of the federal laws.

Without this sense of stability, taxpayers may decide to hedge their investments, betting on the return of tax preference items rather than making major commitments to long-term investments based on economic soundness.

Having said all of this, Mr. Chairman, I would hasten to tell you that we view the current budget deficit as being one of the most serious problems facing the country today. We believe that tough choices must be made in order to reduce the deficit.

I further believe that spending cuts are more appropriate than revenue increases and that Congress has not done all it can to control Federal spending. As a chief executive officer, I have been faced over the past several years with a number of unappealing choices necessary to keep my company vital and competitive. Other CEOs have faced the same choices at virtually every business in this country. And those choices have led to the elimination or substantial reduction of programs and departments within our companies that were considered necessary when they were established.

We appreciate, however, the fact that your committee has been given binding instructions by Congress to raise $19.3 billion in new revenues for fiscal year 1988 and almost $65 billion in new revenues over 3 fiscal years. I personally believe that the amount is far too high, particularly because that amount falls so soon after large tax increases in 1982 and 1984 and for much of America as a result of the Tax Reform Act of 1986.

Let me note, Mr. Chairman, that after the Deficit Reduction Act of 1984, corporate America found itself barely in a better tax situation than it was in 1981 prior to enactment of the Economic Recovery Tax Act. The Tax Reform Act of 1986 shifted at least another $120 billion from individuals on to corporate America. That may be the best argument I can make at this time for your committee to resist any further increases in corporate taxation.

As far as revenues are concerned, I believe that the time has come for a strong, concerted effort to crack down on noncompliance. The fact is, Mr. Chairman, that the previous tax structure of high rates and special preferences created an environment that encouraged both tax avoidance and noncompliance. The new structure of low rates and fewer preferences creates an unusual opportunity to bring about a new climate for compliance and in all likelihood to raise substantial new revenue in the process.

One proposal that addresses this problem has been advanced by a member of your committee, Representative Dorgan. His proposal, which is supported by practitioners and former IRS commissioners, would address the underground economy and the tax gap problems. Congressman Dorgan's proposal would raise new revenues and at the same time improve the administration of the Tax Code.

Mr. Chairman, I hope this committee will not consider a rate increase as a means of deficit reduction. Such an increase would reopen the Pandora's box that members of this committee managed to nail shut last year—the Pandora's box of special tax preferences for special interests to be paid for by higher rates.

I am sure you, Mr. Chairman, and the members of your committee will remember our support of the tax reform process during 1985 and 1986. We were proud to be a part of a process that resulted in the finest Tax Code in my memory. As your panel considers its reconciliation instructions, I hope you will protect the high standards of tax reform.

Chairman Rostenkowski said recently that it is imperative that we avoid undoing the Tax Reform Act, particularly the rates, and we agree with that.

Once again, I want to thank you and the committee for this opportunity to present our views on tax reform and the difficult problem of reducing the budget deficit, and when the time comes, I will be happy to answer any questions you may have for me.

[Statement of the CEO Tax Group follows:]

STATEMENT OF THE CEO TAX GROUP

The CEO Tax Group is a group of chief executive officers of major corporations that strongly supported -- and still strongly supports -- the income tax reforms enacted last year -- and especially the lower tax rates under that law.

The CEO Tax Group believes that the Congress and the Administration made a compact with U.S. taxpayers -- both individuals and corporations -- that if taxpayers were to lose many of their tax preferences, they would receive **lower tax rates** in return. Individuals and corporations have given up a substantial number of their tax preferences, even though the low rates that were traded for are not yet fully effective.

If Congress decides to raise the individual and corporate rate structures, it will be repudiating its compact and breaking its word with the American people. In addition, enormous pressures would be applied to restore preferences repealed or curtailed in last year's Act.

Since the enactment of TRA '86, a major goal of the legislation has been achieved: investment decisions are being made based on economic, rather than on tax consequences.

The CEO Tax Group urges Congress to leave the phased-in rate structure in place, so that its beneficial economic effects may be felt and individuals and the business community can assess its impact. Many corporations -- because of the way their fiscal years are set up -- have yet to feel the first reduction in the top marginal rate for corporations. Individuals across the nation have yet to feel the full effect of their substantially reduced rates, although they have lost many of their preferences.

Tax reform would not have been possible without a substantial reduction in the tax rates on individuals and corporations. Indeed, the economic benefits that would flow from **low rates** were the primary driving force behind the tax revision effort.

Low rates led some members of Congress to craft tax reform proposals, and led President Reagan to instruct the Treasury Department in his 1984 State of the Union message to develop a tax reform package for fairness, growth, and simplification.

The promise of **low rates** successfully helped the Committee on Ways and Means to take the lead in writing tax reform legislation in 1985.

Low rates resurrected tax reform when it was dead in the Finance Committee in 1986, and **low rates** helped the conferees withstand enormous pressures and subsequently achieve the Tax Reform Act of 1986.

The CEO Tax Group views the current budget deficit as an extremely serious problem. As difficult as the task before you, we urge this committee not to fashion a deficit reduction proposal that changes or delays the fundamental cornerstone of tax reform -- the income tax rate reductions.

Allied-Signal, Inc.
Beneficial Corporation
Dayton Hudson Corporation
Emerson Electric Co.
Federated Department Stores, Inc.
General Motors Corporation
Hallmark Cards, Inc.
Hewlett-Packard Company
IBM Corporation
J. C. Penney Company, Inc.
Kraft, Inc.
Levi Strauss & Co.
Merck & Co., Inc.
3M Company
Pepsico, Inc.
Pillsbury Company
Primerica Corporation
Procter & Gamble Company
Sara Lee Corporation

Mr. STARK. Thank you very much, Mr. Richman. Mr. Caspersen.

STATEMENT OF FINN M.W. CASPERSEN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BENEFICIAL CORP.

Mr. CASPERSEN. Thank you, Mr. Chairman. I very much appreciate the opportunity to testify before you today.

As you may recall, I testified before this committee 2 years ago to express Beneficial Corp.'s strong support for your efforts—successful efforts—to reform the tax system. We believed and we believe now that the Tax Reform Act of 1986, which resulted in large part—in very large part—from this committee's efforts, provides a cornerstone for a tax system that will provide for the financial health of our country, its citizens, and its businesses over the remainder of this century.

Today I'm here to explain why we believe this committee should not abandon these tax reforms; tax reforms so recently won and crafted with great difficulty; tax reforms such as broadening of the tax base, lowering of tax rates, eliminating special deductions, tax credits, and other preferences.

We supported the passage of the Tax Reform Act of 1986 from its inception through its enactment for one simple, overriding reason: we believed it would benefit our customers. I speak from the perspective of America's leading consumer lender—a lender whose customers are the American middle class, typically in the $20,000–$40,000 income range.

To our customers, tax reform has meant looking forward to paying less taxes and having more disposable income to spend, to save, to invest. The one promise—the single promise that the taxpayers remember—was that each would pay a fair share, from the Joneses to General Motors. And I submit that that sense of fairness will be broached if rates are lifted. Congress must not renege on its promise to the American public to lower tax rates and level the playing field. That's not a trite statement; that's true. It would especially strain the credibility of Congress in the eyes of the American public to be perceived as abandoning that pledge even before the full impact of the lower tax rates has become effective.

I well remember at the inception of the tax reform movement that cynics said there could never be a bipartisan support of a bill which both lowered rates and reduced and eliminated tax preferences. They were wrong.

At the end of the tax reform movement, cynics said this was just step one. Now that we have a broad-based pact, we will see Congress raise rates once again. And I would certainly hope to see them proved wrong once again.

When we started down this road of reforming the tax system with you in 1985, we felt the test of whether the goals of fairness and simplicity had been accomplished would be that, and I quote from my testimony before this committee: "When the dust settles, the average American feels he is better off as a result of these changes and specifically that his or her tax burden has been reduced." I would submit to you the dust has not settled when the act is not even fully implemented.

I join with my peers in the CEO Tax Group and others to urge that Congress not make significant changes in tax rates but keep the compact that was made with the American people. We believe that a failure to keep this pledge could cause a loss of credibility so severe that the average American taxpayer's view of fairness will be breached, and cynicism and doubt will once again guide taxpayers across America.

We supported tax reform even though Beneficial Corp. would pay additional taxes—taxes of more than $100 million over the first 5 years. We did this because, like our counterparts in the CEO Tax Group, we understood that the benefit of tax reform to our customers and the fundamental fairness which follows from eliminating special preferences and creating a level playing field will ensure that business decisions are made on market motivation—not tax considerations. This in turn we believe—and frankly, we are already seeing—will lead to a more efficient and stronger economy.

Beneficial Corp. and others have already taken action and made plans under the new tax rules. We are disposing of subsidiaries that were based solely on tax considerations such as leveraged leasing operations. Personnel salaries have been changed to emphasize cash compensation and eliminate perks. Assets are bought and sold based on productivity and not tax considerations. Expenses which we now bear the burden of and not shared with the Government are being pared because it's in our interest to lower expenses. The raising of rates would change that.

Our corporate planning for near-, medium-, and long-term has been far less concerned with tax consequences because of the reduced rates. If tax rates are increased, tax considerations will play a more important role, and that is what we all do not want.

Budget deficits clearly continue to be a problem; we understand that. But they are a problem that existed before tax reform. Tax reform was not designed to solve the deficit problem, except insofar as the economic activity would be stimulated by a fairer tax system. This benefit has not—has not—had time to be realized, since the tax rate reduction has only partially been implemented.

The budget deficits can and should be resolved without destroying the fabric of tax reform which was adopted last year. Reductions in spending for defense, entitlements, and public works should help solve that. And there is a possibility they could be coupled with temporary taxes.

We strongly oppose a rollback or a delay of tax reductions. If the provisions of tax reform are left essentially intact throughout the transition period, special interest groups will not have an opportunity to once again seek preferential treatment. In other words, if we abandon the essential elements of tax reform before the economic results can be measured, we will have foregone tax reform and will be back to business as usual.

Both business and individual taxpayers must be given an opportunity to plan and conduct their affairs with reasonable certainty as to how they will be taxed. I urge you not to turn back the clock on tax reform so early in the game and indeed not to do it at any later stage.

Thank you.

[The prepared statement follows:]

STATEMENT OF

FINN M. W. CASPERSEN

CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER

BENEFICIAL CORPORATION

Mr. Chairman and members of the committee, my name is Finn Caspersen. I am Chairman of the Board and Chief Executive Officer of Beneficial Corporation and I appreciate your invitation to appear before this committee to express Beneficial Corporation's views on proposed revenue options in connection with the fiscal year 1988 Budget Resolution.

I testified before this committee two years ago to express Beneficial Corporation's strong support for your efforts to reform our tax system. We believe that the Tax Reform Act of 1986, which resulted in large part from this committee's efforts, provides the cornerstone for a tax system that will provide for the financial health of our country, its citizens and businesses over the next decade and beyond. Today, I am here to explain why we believe this committee should not abandon the tax reforms, so recently won and crafted with great difficulty; such as, broadening of the tax base, lowering the tax rates, and eliminating special deductions, tax credits and other tax preferences.

We supported the passage of the Tax Reform Act of 1986, from its inception through its enactment, for one simple reason...**we believed it would benefit our customers.** I speak from the perspective of the leading consumer lender in the country. Our customers are the American middle class, typically in the $20,000 to $50,000 income range.

To our customers, tax reform meant looking forward to paying less taxes and having more disposable income to save, spend or invest. Tax reform also meant that each taxpayer would pay their fair share of the tax burden...from the Joneses to the largest corporation. The proposals contained in the staff revenue options provide methods for delaying the implementation

of the tax rate reductions and reducing other provisions which were a bargain for part of the Tax Reform Act of 1986. **Congress must not renege on its promise to the American public to lower tax rates and level the playing field.** It would especially strain the credibility of Congress in the eyes of the American public to be perceived as abandoning that pledge even before the full impact of the lower tax rates have become effective.

When we started down this road of reforming the tax system with you in 1985, we felt the test of whether the goals of fairness and simplicity had been accomplished would be that, and I quote from my earlier testimony, "When the dust settles the average American feels that he is better off as a result of these changes and, specifically, that his tax burden has been reduced." In my opinion, the dust has not settled on tax reform. Indeed, we are only a half-year into it and there is already much discussion and much pressure being brought to increase tax rates, and to eliminate other deductions and impose greater tax burdens on the American people--in other words--to undo tax reform.

I join with the CEO Tax Group and others to urge that Congress not make significant changes in tax rates, but keep the compact that was made with the American people last year. We believe that a failure to keep this pledge could cause a loss of credibility so severe that the average American taxpayer's view of fairness will be breached, and cynicism and doubt will once again guide taxpayers across America.

We supported tax reform despite the fact that Beneficial Corporation would pay additional taxes of more than $100 million in the first 5 years under tax reform. We did this because, like our counterparts in the CEO Tax Group, we understand that the benefit of tax reform to our customers, and the fundamental fairness which follows from eliminating special preferences and creating "a level playing field," will insure that business decisions are based on market motivation not tax

considerations. This, in turn, we believe, will lead to a more efficient and stronger economy in the long term.

Beneficial Corporation and many others have already taken action and made plans based on the new tax rules and the rates that will apply under the Act passed last year. We are disposing of a leveraged leasing subsidiary, which sheltered the taxable profits of our core consumer finance business.

Our corporate planning for the near and medium term has been far less concerned with tax consequences because of the reduced corporate rates that were adopted last year. If tax rates were increased, tax considerations would play a more important role in business decision making. As was so frequently the case in the past, this would be to the detriment of more clearly focusing the capital and resources of the company on income producing activities.

Budget deficits clearly continue to be a problem, but they are a problem that existed before tax reform. Tax reform was not designed to solve the deficit problems--except insofar as general economic activity would be stimulated by the lower tax rate structure. This benefit has not had time to be realized since the tax rate reduction has only been partially implemented and, then, not even for a full tax year.

The budget deficits can and should be resolved without destroying the fabric of tax reform which was adopted last year. Without suggesting what is best, reductions in spending for defense, entitlements, and public works could be coupled with [redacted] temporary [redacted] taxes.

We strongly oppose a roll-back or delay of the tax reductions, or further erosion of the tax preferences remaining in the law following passage of the Tax Reform Act of 1986. If the provisions of tax reform are left essentially intact

throughout the transition period, special interest groups will not have an opportunity to once again seek preferential treatment. In other words, if we abandon the essential elements of tax reform before the economic results can be measured, we will have foregone tax reform and will be back to business as usual. Both business and individual taxpayers should be given an opportunity to plan and conduct their affairs with reasonable certainty as to how they will be taxed. I urge you not to turn back the clock on tax reform so early in the game.

Mr. STARK. Thank you very much, Mr. Caspersen. Mr. Jacobson.

STATEMENT OF ALLEN F. JACOBSON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, 3M CO.

Mr. JACOBSON. Mr. Chairman and members of the committee. I appreciate this opportunity to express our views on the Tax Reform Act.

My name is Allen Jacobson. I am chairman of the board and chief executive officer of the 3M Co., which some of you may know as the Minnesota Mining & Manufacturing Co. And I'm here to urge that we complete on schedule the job of tax reform we began last year.

To put our position in perspective, let me tell you a little bit about the kind of company we are. 3M is a highly diversified international company with sales of $8.6 billion last year. 3M has operations in 35 States and 49 countries around the world. We have 81,000 employees worldwide, including 48,000 people in the United States.

We are a manufacturing company. You may know us primarily for our consumer brands: Scotch brand tapes and video cassettes and Post-It brand repositionable notes. But in the great majority of our businesses we serve industrial America with products like coated abrasives, which is a high-tech name for sandpaper; connecting and testing equipment for telephone systems; systems for connecting electronic chips to the outside world; and many other products. We produce 50,000 products using 100 technologies.

We have a strong commitment to research, to development of new products, and to the steady growth and creation of new opportunities.

We are a positive contributor to the U.S. position in world trade; 3M is the 33d largest exporter in the United States. We export more than twice the dollar value of what we import, and our exports are growing. Our exports for the first half of 1987 increased 11.8 percent.

With the help of the new tax law and more properly valued dollar, we are gaining market share in our overseas markets. On the average we have been able to lower our selling prices, and that is contributing to our growth in sales.

In addition, we bring into the country a steady flow of dividends and fees from overseas operations.

Because we are a profitable growth company, we pay a substantial tax bill. In the last 5 years in the United States our company's Federal and State corporate income tax expense totaled $1.6 billion, and that's a tax rate of 40 percent over the 5-year period. This rate has risen over the years with 1986 at 42.2 percent.

Now, given our position as a growth company, a research company, and as a positive contributor to U.S. trade, how do we feel about the Tax Reform Act of 1986? Well, we haven't changed our minds on it; we support it. We think it has already begun to stimulate growth in companies such as 3M—in our case, growth in domestic, export, and international business.

Let me tell you what it is starting to accomplish for the economy.

First, the reduction of the corporate rate from 46 to 34 percent will give us and similar companies additional funds to invest in working capital, in equipment, and in research and development. This reduction in rate is the most positive element of TRA 1986. We think it will be a stimulant for the whole economy.

Second is competitiveness. Reduction of the corporate tax rate will make us more competitive in world markets.

During the past year, because of increased manufacturing efficiency, we've been able to decrease the manufacturing cost component of our exports by 3 percent. And as I said previously, in the last 6 months we've increased the dollar value of those exports by 11.8 percent. Now, I think that's competitiveness.

In addition, the corporate tax rate of 34 percent is shifting incentives from investing outside the United States to manufacturing inside the United States and export of products. We need some stability in tax rates to plan these long-term investments. At 3M our capital expenditures in the United States in 1986 were $500 million. In 1987 they're rising 10 percent to $550 million. And next year we expect them to reach $600 million. I think that shows that there is life without investment tax credits—life based on growth and lower taxes on products. Research and development expenditures were $564 million last year, up 70 percent in the last 5 years and continuing to grow.

Third and finally, reducing corporate tax rates and eliminating tax preferences has accomplished a number of other things. It makes tax avoidance consideration a smaller factor in business decisions. It puts all industry on a more equal footing under the tax laws. And it requires business to pick up a larger share of many business expenses and reduces the Government's share of those expenses. In our experience, this factor is already leading to greater cost control and improved efficiency in American business.

I've been talking about corporations—and more specifically 3M. Now I want to say a word about individual men and women and how they're affected by tax reform.

I said a little earlier that 3M is a research company. Our goal is that 25 percent of our sales each year come from products introduced in the last 5 years, and we're meeting that goal. Now, where do all these new products come from? They come from people—people who are skilled and intelligent, people who are motivated, people who are entrepreneurs within the corporation, people who derive their income not from dividends or capital gains but from salary.

I firmly believe that reform of personal tax rates has already had an effect on people's motivation. I can tell you this: since the bill was passed, I've heard more people talking about improving their incentive pay through performance and fewer people talking about sheltering their income. So the real benefit from what we've accomplished in tax reform is not just leaving more money in people's pockets; it's motivating them, letting them shoot for the sky if they want to and retain a larger share of the benefits and in the process creating economic opportunity.

I think we're beginning to see some effects already. Last year in our company 30 new businesses or product lines reached the $2 million mark in sales. That's up by one-third over the year before.

In the first 6 months of this year we had a 32-percent increase in patent applications. I want our people to continue to shoot for the sky. I want them to do their level best for their company, for the economy, and for themselves. Reforming personal tax rates was a big step in this direction, and I hope you'll give reform a chance to work.

So in summary we believe that the Tax Reform Act of 1986 is a stimulant for industrial efficiency, a stimulant for personal performance, a stimulant for economic growth in our domestic and international businesses. We vigorously urge that you leave it in place, unchanged, until we can see its full impact.

To stay competitive, manufacturing needs to be able to make long-range plans, and that means we need a stable tax system. We believe that over time TRA 1986 will help produce a competitive, prosperous, and expanding manufacturing base in the United States—a manufacturing base essential to our future.

I respectfully ask that you give the Tax Reform Act of 1986 a chance to do the job it was designed to do, and I thank you for the opportunity to talk to you this morning.

Mr. STARK. I want to thank the panel for their testimony. I would just like to inquire of each of you of a proposal that I have some personal interest in. I share your view that we should not change rates, but it's occurred to me that if we are going to try and do something—if we run out of excise taxes and compliance and cash flow speedups—would you be any more receptive or would you have any less objection to the Stark-Chafee approach, and that is to reduce deductions and preferences by a flat amount—say reduce 10 percent. Keep the same rules. This would fall perhaps more heavily on corporate preferences and probably individual deductions and preferences. It would raise, $4, $5, $10 billion a year, I suppose, depending on how quickly it was put into effect. And it seems somewhat more progressive than just a surtax. This in effect would be a surtax on deductions rather than on net income, and I just wonder if that would be a more palatable poison.

I just ask you in the order you testified how you'd react to that approach. Mr. Richman.

Mr. RICHMAN. Congressman, I'll give you my own reaction to that. The Tax Reform Act, it seems to me, was a package of give-and-take. We all gave away something; we got something. The result was a bill—it was a compact, if you will, and it seems to me when that begins to unravel, whether it unravels because of rates or because of reduction of preferences, you face the same kind of problem that I think all three of us addressed in our remarks.

Mr. STARK. Would you all concur on that?

Mr. CASPERSEN. I would concur. It was really a bargained-for position. We all gave—that was the nature of the process. And what was so surprising—that you got proponents from the consumer spectrum, proponents from the business spectrum, and everybody bargained and gave up something. And to unravel that at this juncture—because some gave up tremendous preferences, some gave up tremendous rates—that would be a significant problem.

Mr. STARK. Well, let me give you one other alternative. If we followed that path, I'm not sure we'd find the $19 billion, quite frankly. I'm not sure it's around in all the other little ways.

The second question is that an alternative that may face us is putting the trigger back in and going back to sequestration, which I suspect would only fall on 3M in that it would take a much heavier bite out of defense than the current budget proposal. The rest of you probably are not as involved. How would you feel about that as an alternative—just go on an across-the-board sequestration trigger and let the hurts fall where they may?

Mr. JACOBSON. I would favor that approach.

Mr. STARK. More than taxes.

Mr. JACOBSON. Yes. You say it would hit defense. We are not particularly big in any defense activities.

Mr. STARK. Mr. Richman.

Mr. RICHMAN. Congressman, I'm just not familiar enough with what the impact of that would be across the economy.

Mr. STARK. But we're not sure either.

Mr. RICHMAN. It wouldn't impact us, but I just can't tell you how it would impact the economy.

Mr. STARK. Mr. Caspersen.

Mr. CASPERSEN. I would also plead ignorance on the impact on the economy, but at first blush I must say that has a lot to recommend it.

Mr. STARK. Thank you. Mr. Pickle.

Mr. PICKLE. I want to commend the panel. This is an outstanding panel, and we appreciate your testimony.

I don't have to remind you that this is a problem we are facing without a lot of volunteer spirit. We have been given a job of trying to raise $19.3 billion in revenue. I don't think we want to change the tax laws or bill of 1986, and I can sure understand why you'd want to keep it exactly like it is in essence.

Our problem, though, is where and how do we raise $19.3 billion? Now, I notice none of you recommended how we can do it. One of you—I believe Mr. Richman might have said—that we might raise revenue by enforcing compliance. That is, go after the tax evader, and that's an approach always to be desired. So perhaps that's one angle.

Do any of you have any recommendations? I don't think you came here to urge us to tax somebody else. But we're faced with the problem of how do we raise the funds, so we've got to do it in big steps somehow or another. So my first question would be to you: is it appropriate for Congress to take the approach to try to raise $19.3 billion in revenue in order to reduce the deficit? Do you think that would affect business adversely, if we did that?

Mr. RICHMAN. Congressman, let me give you my own answer to that. I would really attack the spending side first, sir, if you're asking my view—attacking the spending side is very difficult. I tried to say that it's difficult within our companies, and it's difficult in the country. But I think it would be far more——

Mr. PICKLE. Do you think that we——

Mr. RICHMAN [continuing]. Beneficial to the country to do that, and second—just to finish the thought—I really believe there is something in the recommendations of the task force of Representative Dorgan.

I think that the previous tax structure lent itself to tax avoidance—all of the special preferences and high rates and so forth.

And I think there is a real opportunity now with low rates and fewer preferences to attack this problem of compliance, and if that produces $100 billion over 5 years, that's pretty good.

Mr. PICKLE. Well, I think the Congress already emphasized the tax collection and an intention to crack down, as you said, on the noncompliance. There's no disagreement I think with anybody on that.

But do either of you think that we can achieve deficit reduction by just cutting spending alone?

Mr. JACOBSON. Do we think that?

Mr. CASPERSEN. I think that it could be done.

Mr. PICKLE. I hear hesitation and some mumbling out there. But it's not likely that we're going to do that, and we can take it.

Let me ask you one other question. It's been recommended that if we advance this revenue raising measure, that we ought to also couple it with sequestration. That is, if we don't achieve the $19.3 billion level, then automatically the balance that we haven't raised would be achieved by a cutting in spending across the board—both on defense and on domestic programs. Do you think that should be coupled with this proposal?

Mr. JACOBSON. Yes. I think you should do the sequestering.

Mr. PICKLE. All right. Thank you, Mr. Chairman.

Mr. STARK. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I'd also like to thank the committee.

I think it would have been well if all the witnesses today had sat in on the House hearings of the last 10 days on the budget and on the appropriations bill when many of us tried to reduce the budget on certain items across the board.

We hear a lot of talk that if we cut defense—there's only 100 percent in the dollar on defense, and every governmental group or agency that has been created wants some more money, and they say, "Well, take it out of defense; take it out of defense." But there isn't that much money in defense.

Prior to indexation of taxes—through the years Congress had been given our new revenues—unlegislated revenues came into the Treasury because of inflation. But instead of applying it to the debt, we merely created new Federal expenditures and spent the money. So consequently, giving the Congress more money certainly doesn't solve complex problems.

Do you have any other ideas that you'd like to expound on here—since you've heard the other witnesses. But it is a very serious problem, and until—I know that reducing expenditures alone won't do the job, but there are other things that we can do with it if we're serious about it. Because I've never said that the deficit that we have is a Presidential deficit. In fact, it's a congressional deficit. Only we appropriate the money in the Congress—not the President.

Do you think spending more money solves our problems or—Mr. Jacobson, do you?

Mr. JACOBSON. No, I don't feel that more spending will solve our problems. I think you have a very difficult job of judging some cuts that should be and can be made in Federal spending. And I think we should move ahead on some of those.

Mr. DUNCAN. Do you favor across-the-board reductions?

Mr. JACOBSON. Across-the-board or some long-range selective ones on large items of expenditure.

Mr. DUNCAN. Thank you, gentlemen. Thank you, Mr. Chairman.

Mr. STARK. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

I'd like to thank all the panelists for their testimony today. I would also commend you for the assistance that you gave to this committee and the Senate Finance Committee and the administration in 1985 and 1986 in getting the Tax Reform Act of 1986 legislation passed. Without the help of you and others, we would not have had tax reform. And we greatly appreciate your efforts on behalf of the Tax Reform Act of 1986.

I tend to agree with you in terms of the rates situation. I do not believe that we should tamper with the rates at this time. There's a lot of cynicism out there among the American public saying that the 28-percent rate and the 34-percent corporate rate will never really hold because Congress will take it away, and I think we have to show that we do have credibility.

I believe Mr. Richman testified that once you begin to increase the rates, you automatically create a situation where people are going to seek relief through more preferences. I think capital gains, ACRS, and other preferences will have to come back, and we will be forced to do it. The tax shelters business will come back. And so I think there's very legitimate reasons for your testimony.

One of the problems is that with the exception of labor and of some of the poverty groups, all of the groups that testified yesterday were basically saying, "We don't need a tax increase." And they are starting off with that presumption.

As you all know, because of the budget resolution, and we do want to sincerely reduce the deficit, we are stuck with considering raising revenues. And in view of the fact the President's budget proposal only received 27 votes in the House and 18 in the Senate, if we sincerely want to reduce that deficit, it has to be a mix of both spending cuts and also tax increases.

I really have a problem with excise taxes after hearing testimony yesterday. If we're unwilling to deal with preferences and unwilling to deal with the tax rates, that probably leaves Mr. Dorgan's proposal on compliance as the only area we can raise revenues.

In 1986 Senator Packwood came in with his plan to lower rates through the use of excise taxes without eliminating preferences. Many people at that time suggested that such an approach was a copout, and wasn't truly tax reform.

And as a result of that experience I'm starting to think that perhaps the way we really have to deal with this issue is to deal with it as a zero-sum game. In other words, if we keep the tax reform rates, we're going to have to do everything we can to reduce and eliminate preferences.

But for us to raise excise taxes is unfair, because all of a sudden now we're going to be asking those that are impacted by excise taxes to be responsible for the deficit.

And with that, I'd like your comments on raising revenues. If we say that rates are as high as they should be and I think they are—I don't think we should tamper with those rates—then the choice be-

comes excise taxes or preferences. Where do we go? I'd like your good faith, honest statement.

Perhaps Mr. Richman would like to start and the three of you could briefly respond.

Mr. RICHMAN. Congressman, we don't—I speak for myself—I don't underestimate in any way the difficulty of the problem that the committee faces. I think you can understand why we don't necessarily come in here with a legislative program, if you will. I'm not an economist or a tax expert, and I simply haven't done the kind of study in terms of economic impact on the country and so forth that I think is really required before you move to excise taxes, for example, which—as the argument goes—can have a lot more effect on the working poor and so forth.

And I guess we also start with the belief that more can be taken out of spending. I think we've all faced up to it back home, if you will. And while there are differences and while it is unappealing and unpalatable, I think it can be done. So it's not—I don't view personally saying that it can—that the $20 billion can come out of spending. I don't view that as a cop-out. I personally think that it's probably——

Mr. MATSUI. I wasn't suggesting that.

Mr. RICHMAN. No, I know.

So with that, Congressman, I don't think Representative Dorgan's proposal has been explored enough. It's been interesting to me from the beginning, for example, because just as I believe something can be taken out of spending, I believe there's a lot of money there in the compliance area. And I think it's been fed over the last 10 or 15 years because of the crazy-quilt tax law that we've had with all of the loopholes and special preferences and so forth, and I think everybody's been looking at everybody else, if you will, both on an individual basis and a corporate basis and saying, "Well, gee, if he can do it and he's not paying any taxes, then there must be ways for me to do it," and so forth.

So I think that quite apart from the revenue raising aspect, the time has come for a real hard look at enforcement. And I think that requires investment, by the way. I don't think that simply says we can stay where we are.

So that would be where I would approach it. I would look very hard initially at that area. And I just tend to believe in my own gut that there's some gold in those hills.

Mr. MATSUI. Thank you.

Mr. CASPERSEN. It's a hell of a problem, and it can't be solved by glib statements and can't be solved by saying "tax anybody else but stay out of my back yard."

Part of the problem is the incredible schedule that this committee has been given. You've been given—you've been told to raise $20 billion on the morning after what is clearly the most dramatic tax reform act of this century. And then you're also told to do it fairly—don't break the compact, all of which you want to do. We all want to work for that.

And how do we do it? We have a good, but voluminous Joint Committee report, and then within 30 days we have to sift through that—I haven't sifted through it; my staff hasn't—and come to an

analysis and then decide what's good for the country and decide what's palatable and then bring it to the floor.

It's a hopeless schedule. You've got to have more time. This is an incredibly basic problem, and just to wham-slash-bang do it 1-2-3—it's not going to be done right unless it's by pure luck.

So we've got to think this through, and that means some analysis. There's got to be something on the revenue side that was overlooked. But a lot of those preferences were bargained for, and we've got to balance that.

But you need time. You can't do it in 2 weeks. It's hopeless.

Mr. MATSUI. I appreciate that. Thank you.

Mr. JACOBSON. Mr. Congressman, I certainly agree it's a difficult job.

I think, as I said, the current Tax Reform Act has given us a more competitive stance, and I would hate to see us lose that in any way. I think the rates are of primary importance. If you can broaden the base in some ways by eliminating some preferences, that's probably the best way to go. I would—there might be some excise taxes that would be not too harmful to the economy in general.

But I would avoid any that get into the materials stream. In other words, a tax on oil, which gets into a lot of petrochemicals, a lot of the materials that we use and ultimately want to export the product. It would make us less competitive in those things. So I think we're—we would like you to judge the competitive aspect of any of these changes.

Mr. MATSUI. I'd like to thank all three of you for your comments.

Mr. STARK. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

In all due respect to the gentleman on my right and his proposal—Mr. Dorgan's proposal—I just can't help but feel that in the first year after a dramatic, huge review and rewrite of the tax law that we're not going to get any dramatic increase in revenues. If not impossible, it's probably improbable, though I thank Mr. Richman for being the one to make some suggestions.

I would also like to say to Mr. Caspersen—you say we don't have time—that we received a booklet which contained about 293 pages of possible revenue increases. We reviewed—this committee reviewed—the Tax Code extensively over the last 2 years for tax reform so we do know where those remaining preferences might lie which could be further eliminated.

Saturday at my home—the Fourth of July weekend—was jeweler's day. They called all day to express their upset over the possibility of a luxury tax—which is perfectly their right, and they knew I'd be home. So fine.

I don't want to elongate this thing—I really don't. But it should be clear that we're not going to find any easy answers.

You represent the CEO Group, and you yourselves are people who many of us respect, deal with in our home communities and are leaders in our communities. My chief executive officers are constantly saying to me, "Barbara, you have to reduce that deficit. You're mortgaging your child's future; you're hurting this country; you're hurting business. Reduce the deficit." I hear that constantly.

And yet when I hear your testimony this morning, I almost feel—and I'm not being critical since we're seeking answers here—I almost feel you're not only saying to us, "Hold it now. You just did tax revision. Let's see what's going to happen," but are also saying to me, "Don't do anything about the deficit this year," because obviously we can't make any unpopular choices. The President's in my home State today saying we're tax-and-spend Democrats. He's going to veto the tax bill. Are you carrying to me the message of my home chief executive officers, or are you saying to me very sincerely, "Let's wait"?

Mr. RICHMAN. Well, I'm certainly not saying don't reduce the deficit. What I am saying is that as far as trying to reduce the deficit by tinkering around with the Tax Reform Act that was passed last year and beginning to unravel it would be a great mistake.

I think with what Mr. Jacobson said—I think the effect of this Tax Reform Act is going to be a very beneficial one for the economy over time. I think we are going to see what business incentives can do for our economy as opposed to tax incentives. And I think that may bring in greater revenues over time, too, by the way. Now, I can't tell you by how much.

So I think we still have to look—and very hard—at the deficit. I again would approach it by looking at the spending areas and you're quite right when you say that the compliance effort is not going to do much the first year. I think by definition we have to invest in a stronger compliance effort. But I think that over—the 5 years increased revenue figure given by the task force is $100 billion.

That's pretty good. And to me the important thing about the deficit is not balancing it by the end of 1987 or 1988—we're not going to do that. The important thing is to get a trend line going. That is, bringing it down year by year by year. And I think a combination of leaving the Tax Reform Act in effect, of attacking spending, and of focusing strongly on what we can get out of increased compliance all will aid toward that trend line going in the right direction.

Mr. CASPERSEN. I would echo those thoughts exactly. As far as the Tax Code is concerned, I'm saying let's wait. Don't tinker with it. I think you're going to see benefits from that reform act that are far beyond what the professionals think are going to come out of it. And I'd watch spending like a hawk.

Mr. JACOBSON. I'd agree. Watch the spending and——

Mrs. KENNELLY. Excuse me. I can't hear you, Mr. Jacobson.

Mr. JACOBSON. I said I would agree with my colleagues—watch the spending side of it, make some cuts in some of the major items which are going to be a problem for a long time if we don't do something about them. And let's see the kind of economic development that's going to come out of this tax law.

And I think there's one other thing. We see much of the rest of the world moving toward a lower tax—income tax rate. The United Kingdom is already there. I just came back from Europe. Germany's talking very seriously about—you know all of these things, and I would not want to see us in some less competitive posture than we are now.

Mrs. KENNELLY. Well, I agree that a covenant was made a year ago. And by the way, I thank you too also for the support. There's

an awful lot of people who aren't around that were there helping who aren't admitting it. And thank you for at least admitting you were there and you're still there.

But I just feel that something's got to give. And I guess it's—you're not only going to have to talk to us. You're going to have to go up to some of your friends in the executive branch and tell them there's got to be some give there too. Because we're willing to bite the bullet. But this veto threat that we have hanging over our heads means we bite the bullet on this committee, and then the members say, "Why? It's going to be vetoed." So I would ask you to give—just in conversation—give the same testimony to some of your friends in the executive branch.

Thank you very much.

Mr. STARK. Mr. Frenzel.

Mr. FRENZEL. Thank you, Mr. Chairman.

I am pleased to see the panel. I thank it for its contribution and tell you if you are taking credit for passing the Tax Reform Act, I'm delighted to give you that credit.

All of you testified that you don't want the Tax Reform Act rate tampered with—that if you had your druthers, you would seek spending cuts rather than tax cuts and that you are reluctant to suggest new taxes on others.

One of the things that interests us on this side of the bank of benches is that in the history—or at least the recent history of the country—when we have enacted new taxes and increased our tax revenues, we have not been able at the same time to claim that those revenues have gone to reducing the deficit. Because, in fact, we have spent them up.

And in the current budget to which the gentle lady from Connecticut refers, I think, in her discussion, there is the $19.3 or $19.4 new taxes. And as near as I can compute, there is about $4 billion in savings in domestic programs. Obviously, we are using—or it is the intention of the Congress—to use new taxes to finance increased spending or new programs. And of course some of those are coming right out of this committee.

Do you see any way to indemnify the taxpayer in such a way that if the taxpayer has to throw some more nickels on the drum that Congress might somehow allow that to go to deficit reduction rather than to satisfy its insatiable profligate appetite for new spending? If that's a leading question, let her go.

Mr. JACOBSON. I was going to say the only thing I would throw on the table is the hard work and good judgment which I think the Congress can bring to this issue and to see that we have spent ourselves into a real problem and that any additional taxes we have collected have gone into increased spending. I think your observation is right, and I hope you and your colleagues will have a positive effect on it.

Mr. FRENZEL. Any other comments?

Mr. RICHMAN. No, I think that is why——

Mr. FRENZEL. I can't say as I blame you.

Mr. RICHMAN [continuing]. A lot of us—and I think I can speak for the three of us on this point—are very leery about revenue increases. Because we don't like them in the first place; we don't

think they're good for the economy. But history shows that they don't go to reducing the deficit. They go to new programs.

Mr. FRENZEL. The next question is that each of you spoke about an agreement which was made in the Tax Reform Act. And certainly the Tax Reform Act was the biggest change—the most radical change in our tax system at least in the memory of most of the people around here. On the other hand, we've had consistent changes in the tax system since I've been around, at least—1974, 1976, 1978, 1981, 1982, 1984, and 1986—fairly major tax changes.

Can any of you tell me how long you expect this covenant that you think exists between you and the Congress to continue?

Mr. CASPERSEN. Well, none of us thought in terms of the rest of the century—for long term, but we did hope it would last more than 6 months. This was a major act, and as we all well recall, we shifted $100 billion—$120 billion of taxes from one sector to another. And for the most part, we got those sectors to agree, at the very least the ones who are being taxed--some said, "Yeah, let's go ahead, because it's going to help us in the longer term." And that was a unique exercise—to have some groups take an overall view.

And to come back so shortly and say, "Ah ha! That'll teach you to be idealistic"—that's going to be remembered for decades, and it's the last time you're going to get a group to come up—or any group of groups—to work together on a major national priority, a priority which I happen to think will help reduce the deficit, not just over the long term, but over the short to medium term because it is more efficient.

And we all know within our own companies—what steps that are being taken. And I think we can see some of the result in the economy already. So the answer is no, we didn't expect it to last for decades, but let's not count it in months.

Mr. FRENZEL. Do the other two witnesses agree that if the agreement or whatever it was is reached, that it will be difficult to gather business support for such ventures in the foreseeable future?

Mr. RICHMAN. You bet.

Mr. JACOBSON. I would agree, particularly since there were some very major and basic changes made in the system. I also think we have to get back to the competitiveness issue and that this Tax Reform Act gives us a better opportunity to invest in the United States rather in other places.

Mr. FRENZEL. Thank you very much.

Mr. Chairman, as one who didn't support tax reform, I think we ought to at least give it the courtesy of seeing whether it's going to save us or kill us. I yield the balance of my time and thank the panel.

Mr. STARK. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Let me first deal with the issue of spending. We doubled the defense budget, effectively, and provided no method to pay for that. So when people talk about some general increase in public spending, I think we ought to understand that principally in the last 6 or 7 years we're talking about a substantial increase in defense spending without the courage to say to the American people, "If we need this, we ought to have the courage to pay for it as we go."

Now, let me, if I might, Mr. Chairman, deal with the issue of the tax gap. Mr. Richman, you mentioned that in your testimony. There seems to be a feeling among some that this is a soft, amorphous area that we don't really understand. In fact, it's been abused because every time somebody put together a budget and couldn't find quite enough revenue, they stuck in a little extra money and said, "Well, we'll get $3 billion from tightening up the tax system."

I put together a task force with a former Republican IRS Commissioner, a former Democrat IRS Commissioner, the former head of the Joint Tax Committee, former Treasury officials, and State officials. That task force worked with me about 3 or 4 months, and it came up with a report.

The report is similar to what you would do in your corporations, I think, if you discovered as CEOs that about 20 percent of your revenue was slipping through the cracks. My guess is that in short order you'd call the best people you have together in your office and say, "Do something about that."

In our Government we have about $100 billion a year that we don't collect because it's not even reported. We have a compliance rate of 81.5 percent, according to the IRS and the Treasury. In other words, we have almost 19 to 20 percent noncompliance rate. Question: What do we do about that? Do we do anything? I think we ought to.

I think we ought to have a very significant program to try and narrow that compliance and tax gap. If we narrowed it by one-third, we'd collect $30 to $35 billion a year in revenue. That amount comes from deadbeats that are now escaping their obligation, rather than going back to the same old folks that always pay with more taxes. Let's get the taxes that are owed by the people who aren't paying. Let's narrow that tax gap.

How do we propose to do it? We can do it with a very significant program that does two things to the revenue collection system. One aspect would put the service back in the IRS. You won't get good compliance unless people get good service. Let's move the IRS back out into the country. The only contact people have with the IRS now is when they're told they're going to be audited or when they take the initiative to call on a phone bank 300 miles away to try and get a question answered. I think we ought to have a significant taxpayer service component to help the folks that want to comply with their tax obligations.

Second, we also ought to significantly strengthen tax enforcement. We used to audit 2.5 percent of the tax returns; now it's down to 1.1 percent.

Now, again let me point out that this isn't some soft, wishy-washy proposal. It's a long-term proposal that can raise significant amounts of new money for our Federal Government that can avoid the requirement to lay brand new taxes in significant quantities on the people who now pay.

It won't solve the problem this year. We can't find $19.3 billion of new revenue through the tax gap issue this year. But if we follow the recommendations to narrow the tax gap with the very careful approach that this task force has suggested, we can in the

out-years—the second, third, fourth, fifth year—raise a significant amount of money.

I hope that members of this committee will begin to think seriously about that and will join me in doing some more work on it in the next several weeks.

Mr. Richman, I thank you for your testimony on it, because I think we need to highlight that.

Again, you three CEOs would have a meeting so fast in your offices with all the right people saying, "By God, we've got to solve this problem," if you had 20 percent of your revenue being washed away. The Government ought to behave the same way. We ought to think like business people when we deal with this issue.

Mr. MCGRATH. Would the gentleman yield?

Mr. DORGAN. I'd be happy to yield.

Mr. MCGRATH. I think all of us are concerned with the noncompliance and decreasing the degree of noncompliance. Certainly this would be found and easy money for us, had we the opportunity or the time to collect it for this particular fiscal year where we were given a $19.3 billion liability.

My question to you, though—and we all agree that you'd certainly do what you had to do in your corporations in order to accomplish this, and certainly we should be doing this. You say there's $100 billion out there per year. My question is, How many more IRS agents do we have to hire in order to garner this voluntary compliance?

Mr. DORGAN. Let me say I don't think you're——

Mr. MCGRATH. What is the factor of dollars——

Mr. DORGAN. Mr. McGrath, let me reclaim my time and say I don't think it's accurate to say that we're all concerned about that. The fact is, a whole lot of people aren't concerned about it, and that's why we have a $100 billion tax gap. If we were concerned about it, we'd have done something about it a long time ago, and if we're concerned enough, we'll start doing something about it now.

Yes, we will have to devote additional resources to the revenue section of our Government. The estimate is about $3 to $3.5 billion in resources to raise $105 billion in revenue in a 5-year period—not a bad investment, in my judgment.

I wanted to use my time to describe this tax gap proposal, so let me conclude by saying we're going to have to raise some revenue this year because that's our mandate. Now, we don't necessarily like that. But we have to do it. We don't expect anybody to come forward to say, "We're it. We're your guys. We're the ones that want to pay more taxes." There is not a soul who is going to do that in these hearings.

Nobody likes to pay more taxes. Yet in the entire array of revenue raising opportunities—that is, the income tax, the excise taxes, the energy taxes, the whole host of things—we've got to try and select some combination that reaches the mandate that's required in the budget act.

I appreciate your testimony. I've read through it and think it's good testimony.

I'd like to ask one very brief question. Mr. Caspersen, in your testimony you indicated that reductions in defense spending would be appropriate. Now, the White House would have an apoplectic sei-

zure reading that. Do you believe we can cut in real terms the defense budget?

Mr. CASPERSEN. I think there should be nothing sacrosanct in any budget—that if you're going to go ahead and pare a budget—and that's what has to be done—that you can't say, "OK, this is sacrosanct, and we won't cut this, but everything else will be cut." I don't—from my own corporate experience—and I think my associates would echo this—there is always something that you can cut.

Mr. DORGAN. If we were to cut Social Security—something I consider wholly unlikely, incidentally—would we not have a responsibility to cut the dedicated tax that can be used only for the purpose of Social Security? The reason I ask the question is defense is the biggest item in the budget—nearly $300 billion—the next $225 billion is Social Security, and that's wholly funded with the dedicated tax. Any savings you extract in Social Security really have very little to do with dealing with the deficit, because I think if you had Social Security cuts, you'd have a responsibility to cut the Social Security tax. Do you agree with that?

Mr. CASPERSEN. Or in the longer term make sure that it's viable, actuarially.

Mr. DORGAN. Well, I think your testimony is excellent, Mr. Jacobson, Mr. Richman, Mr. Caspersen. Thank you very much.

Mr. STARK. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Gentlemen, I too want to thank you for your testimony. I thought it was very, very good. I share your views about trying to leave the tax reform just accomplished in place as well.

Mr. Jacobson, I was particularly impressed with your statement, because you dealt somewhat with the manufacturing sector, and you talked about the improvements that have been accomplished in terms of market share and growth and opportunity. You pointed out that your company has some 81,000 employees—some 48,000 in the United States.

I think part of our dilemma is that as our manufacturing operations go through this transition that companies, in order to get more competitive, have had to reduce their employees in many areas. Is that experience—have you experienced that? Do you have more employees, as you got more competitive, or less employees?

Mr. JACOBSON. We have about the same number. What we have done is increase our purchases and such from many vendors and suppliers and that sort of thing. But in getting more efficient—more competitive—you don't use a great deal more labor.

Mr. FLIPPO. In many instances where our manufacturing operations have revamped and got competitive, they have reduced their number of employees in many cases by varying percentages, but large numbers of employees are no long with them and while the employees that are still with them are in a much more secure position. And we are able to grow, and that's what we want to do. More and more of those employees are in worse conditions, many of them not having adequate health insurance, many of them not having adequate training to adjust to new and changing economic conditions.

And the burdens then on government grow somewhat, and while we must maintain an environment in which we can grow and pros-

per and be competitive and lean and mean, and new jobs are protected—we still have to be concerned with that 37 million Americans out there without health insurance, with those individuals who need some retraining to adjust to these new locations.

And so that is the kind of dilemma that we are facing that may be somewhat different than corporate executives are facing as they strive to do what they're supposed to do, which is maintain competitiveness and grow and prosper.

Do you have any suggestions how—when you gentlemen suggest that what we have to do is to cut spending—and we can always finds places to cut spending. But we also have growing social needs to address. And do you have any suggestions as to how we might resolve those dilemmas?

Mr. JACOBSON. Mr. Congressman, it's certainly a difficult problem. I would suggest, though, that competitiveness is going to build our economy versus others in the world and that our economy has an unparalleled record in the last few years of adding jobs in total. Now, some of those have not been the quality of jobs that generally come with manufacturing. But there is a record compared to any other country in the world, I believe, of adding employment in the last 5, 6, or 7 years.

Mr. FLIPPO. Yes, I think that adding jobs—that's a great part of our capability, and I hope that that continues. But are you suggesting that the American people today are better off in terms of their purchasing power than they were before we started that job creation? Is our per capita income where it was, because we passed through the baby boom, and we're into the baby bust now. Are you saying we've had real increases in per capita income in the United States in the last few years?

Mr. JACOBSON. I think you can get a lot of figures. My feeling is that we have a general increase, or at least we've held our own. I think we've had an increase, particularly with the tight control of inflation that we've seen in the last couple of years.

Mr. FLIPPO. Well, the only point I'm making, gentlemen, is that there are growing needs of government to address the needs of our people as we transition. That's the dilemma that we face, and I know you understand we face that. The worst thing we can do is to create conditions in which you can't continue to grow and be competitive, and so I share your views in that regard.

Thank you very much.

Mr. STARK. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. It's been a very interesting discussion this morning. I'd like to thank the witnesses.

I'm somewhat baffled in a way because our extraction of dollars from corporate America and individual taxes has increased dramatically over the last 6 years. We have not, in effect, cut the amount of money—we have increased dramatically. During the Reagan years we will have increased by some $400 billion the amount of money we have extracted from the American people.

And so what we're talking about is setting national priorities. When we tax something, we retard it, in effect, and when we do not tax it, we encourage it.

I was interested in yesterday afternoon's discussion. I'm sorry that I couldn't have been here on the taxation of advertising,

where it was stated that there were first amendment problems and other reasons we should not tax advertising. And I'm not saying we should tax advertising. But when we look at this taxing structure as the setting of national priorities, what we're doing is saying that when you expense the purchase of new productive equipment and when you have to depreciate new equipment and yet you can expense other items, you are giving a preference, in fact, to those other items.

So that what we're saying is that it's certainly more important to advertise than it is to buy new equipment. And in that kind of a balance, I'm not sure that we're right. I'm not sure in the long run that that makes us more competitive. I'm interested in the fact that we've discussed competitiveness.

I'm also convinced that there's a limit to the amount we can pour into the IRS, and we can only squeeze that goose that lays the golden eggs so much. There's a limit to the number of IRS agents we can hire, and there's a limit to the amount of pressure the American people will take as we put an IRS agent behind every individual and make sure that we get every last penny.

Part of the Tax Reform Act was to try to encourage better compliance. Whether that will work will take a little bit of time.

Well, let's talk about competitiveness. How about a nice little border tax? What do you think of that—5, 3, 7, or 10 percent—nice, sweet, little border tax?

Mr. Jacobson, you sell all around the world. Let me phrase it a little bit differently. When you sell a product in France—with the way we collect our taxes here, you pay the costs of government in producing that product. When you sell it to France—when it goes across the border—they add a value-added tax and so that we're paying on—your product is also paying the costs of the government in France.

When they make a similar product and send it over here, that tax is eliminated. As a consequence, we—they have an advantage over your products. Why not some sort of a little equalization? Why not a little border tax that would solve some of this problem and help our domestic producers?

Mr. JACOBSON. Let me say I would—I think it's a good question. I'd like to answer your question on advertising and on this, if I might.

In many cases we do find duties and customs going into other countries higher than coming into the United States. And I personally would be very happy to see those equalized. I don't think we should disadvantage our exports by paying higher taxes and then giving people access to our market with very low import taxes. I would only say that this would have to be negotiated, and people would have to understand that it was equal rather than——

Mr. SCHULZE. Let's talk realistically, Mr. Jacobson. Do you think that the Europeans are going to eliminate the VAT? Do you think under any stretch of the imagination that they're going to drop it if we don't?

Mr. JACOBSON. No, I just think——

Mr. SCHULZE. As I look over the next 10 years or the next 20 years, the only way we're going to do that is to put on some sort of border tax. Do you agree or—I don't want another tax.

Mr. JACOBSON. If it is done in a way which matches the costs of our—added to our goods going into their countries, I think it's justified.

Mr. SCHULZE. All right. Then you would look for some kind of reciprocity.

Mr. JACOBSON. Right.

Mr. SCHULZE. OK.

Mr. JACOBSON. Now, on advertising, let me say that most people think of advertising as strictly the consumer advertising. We're an industrial company. You don't see much of our advertising on television. But there's a great deal of it in industrial advertising in trade journals, in cooperative advertising with people who use our products in their products. So to us, advertising is a very real cost of doing business—the same as materials and labor. We can't sell our products to people who don't know anything about them.

Mr. SCHULZE. I'm not saying we shouldn't advertise.

Mr. JACOBSON. No, but I'm saying——

Mr. SCHULZE. But you're saying that it is more important to advertise than it is for us to encourage the purchase of new equipment. In other words, when I'm just balancing buying a new piece of machinery versus my spending that same amount of money, let's say, on advertising to sell more of my products, the Tax Code says, "advertise." It does not say, "buy that new piece of equipment."

I would be happy if it were a level playing field. But what we're—right now it's tilted. And my question is, should it be tilted, or should we say, "No, we want America to be competitive. We want to tilt that playing field on the side of America being the most competitive in production in the world."

Mr. JACOBSON. I don't feel that you're in most businesses making a tradeoff between purchase of equipment and advertising. You're looking at your profit potentials from both of them, and by reducing the tax rate we have made the investment in new equipment more profitable because you look at a better stream of retained earnings.

Mr. SCHULZE. So you don't see that we really are giving any kind of preference and that the amount of depreciation on machinery or what it costs to buy it has no relation—no correlation.

Mr. JACOBSON. None at all.

Mr. SCHULZE. OK.

Anybody else want to comment on that?

Mr. RICHMAN. Well, I would agree with that, Congressman. Our company knows something about consumer advertising.

I would simply make two points on advertising to you. Advertising is simply part of a spectrum of communication to the consumer, if you will. Direct marketing, in-store promotions, coupons, all kinds of methods are used to try to communicate information and incentive to the consumer to buy your product. I think to single out advertising for a tax gets you into a morass which is—I don't know where you stop.

Mr. SCHULZE. Does advertising create economic activity?

Mr. RICHMAN. You bet.

Mr. SCHULZE. Does it just say, "I'm going to buy a Buick versus an Oldsmobile or Coke versus a Pepsi," or does it say, "I'm going

out and buy a car." Does it make you buy a car, or does it make you lean toward one brand or the other.

Mr. RICHMAN. I think over time it clearly leads to economic growth.

Mr. SCHULZE. Are there studies that show that?

Mr. RICHMAN. Yes, sir. There is a study—I think I can get you the information. I think it's by Wharton Econometrics, and I think it says that if you——

Mr. SCHULZE. I've read theirs.

Mr. RICHMAN [continuing]. If you cut the deduction by 20 percent, you may lose 185,000 jobs in a year or something.

Mr. SCHULZE. I thank the Chair for being tolerant. I've read. What I'm asking is whether it does really create economic activity in effect by saying, "I'm going to go out and buy a car," rather than just say, "a Buick versus an Oldsmobile." And that study did not address that, and I just didn't know whether there was such a study that would.

Mr. RICHMAN. Let me check that for you.

Mr. STARK. If the gentleman would stand down, the Chair would like to announce that it will be our intention of—clearing this with Mr. Duncan—to work through votes and rollcalls, and if everybody will be a little tolerant as we pass the gavel, and if people are inquiring during the roll call, if somebody will fill in for them, we'll try and move the hearing along and proceed in that manner.

Mr. SCHULZE. I thank the Chair. Unless Mr. Caspersen has something he'd like to add.

Mr. CASPERSEN. Oh, I agree that advertising is just one method of reaching the ultimate consumer, be it a factory for equipment or be it a consumer for a particular service.

Mr. SCHULZE. How about a border tax? You know, I think it's much more important than the advertising.

Mr. CASPERSEN. If it could be crafted on a reciprocal basis, I think that's a very good idea, and it has to be crafted very, very carefully. Because frankly, in our negotiations we——

Mr. SCHULZE. You see, that's kind of tough under the GATT rules.

Mr. CASPERSEN. It's extremely tough, and we always haven't gotten what we wanted in our negotiations.

Mr. SCHULZE. So why not across the board?

Mr. STARK. The time of the gentleman has expired. The Chair will recognize Mr. Moody.

Mr. MOODY. Thank you.

Again, I'd like to thank the witnesses for excellent testimony. I would like to draw you back to your conversation—I think it was with maybe Mr. Dorgan or Mr. Matsui—regarding the effect of taxes on spending. Both—I think all three of you said that you are reluctant to recommend taxes for fear that it'll merely be spent and not be used to reduce the deficit. Well, for 1988 I think we have locked in our spending for better or for worse now. With the budget resolution we are not allowed to spend above it.

The question before us is, Are we going to pay our bills? We went through a difficult budget process. There were tradeoffs made. I'm not on the Budget Committee, but I think they did a pretty decent job. As you know, the alternative budget—the Republican members

of the Budget Committee chose to offer no budget. The President's budget was offered and received a nominal number of votes at best. Five out of six Republicans voted against it, and I think virtually all Democrats voted against it. It didn't have any appeal.

First of all, not only was it not a real cutting budget—I think that in fact the revenues in it were probably less attractive to most people in Congress than some of the revenues we might choose right here. Assets sales were not terribly appealing, and the user charges that were in there—FHA and so forth—were not terribly appealing. So it was rejected.

We're in a position of paying our bills or not. Really, it isn't a question—rushing out and spend the money. We've locked our spending in, and are we going to pay our bills, and I guess the question we have to ask ourselves is not do we like taxes or do we like one set of taxes very much or another set not very much. But does raising taxes—in whatever form we choose to raise them in 1988—is that going to be less serious to the economy, less deleterious to the economy than letting the budget deficit slide up to go past the targets?

We have set, as you know, a $37 billion deficit reduction target. We have enacted in the budget resolution real, genuine spending cuts. It's not as though it's pie in the sky. These are cuts which now we are bound by. These are real cuts. Defense—the President is furious with the defense cuts, for example. Those are real cuts. So we're not going out and spend the money.

But is the economy worse off if we fail to meet our targets, or is it worse off by whatever negative economic impact of whatever taxes we might choose? It seems to me that's the only realistic choice—not philosophic discussions of do taxes lead to spending. The question is: Do no taxes make us worse off than some taxes?

It seems to me that the financial markets are poised to find out whether or not we're going to take our own commitment seriously. I think the international markets are watching the budget deficit. I notice that no private net lending has come to the United States in the last 2 or 3 months. It's been only Government borrowing—private lending is on hold internationally.

If private lending continues to be withheld and foreign governments cannot continue to lend, we may see a tightening of the capital markets which will send interest rates up, and cause a much more harmful effect to the economy. I do not believe there is a free lunch. If we do not pay it through the front door, through the taxes, we do not meet our obligations that way, we will be paying it through the back door, through higher interest rates and other less-efficient ways of handling our obligations.

Does the gentleman want to respond to that? All three of you seem to say let's wait, let's not have taxes. Go ahead, Mr. Richman.

Mr. RICHMAN. Well, Congressman, my answer would be what I guess it has been before. I think what the financial markets are looking for in the budget deficit is directional, not whether or not $19 billion is cut in 1987, and I think that if we allow the benefits of tax reform to take effect, the benefits will be greater than a lot of the experts think it will, in terms of the revenues, because of all of the reasons we have said today.

Mr. MOODY. You do not believe it is really revenue-neutral——

Mr. RICHMAN. I think there are going to be benefits coming from it, Congressman. I really do. I think we can see it and feel it in our businesses, and I would like to see it given a chance to work. I think that again, pursuing spending—and I am not talking about this fiscal year, but I think, you know, it is very tough to attack spending cuts, to attack the issue. It is tough on our companies, it is tough on the country, but I cannot believe that there are programs out there, including defense, that some spending cannot be cut.

And finally, I again would go back to what I think is a real hard reality of some revenues, and that is in Congressman Dorgan's compliance proposal, and again, this is not just a "pie in the sky" thing, this is making an investment in the system to get revenues in.

So the combination of those three things I would look at, and I would look at it directionally, and if they did not take effect during the next couple of years, then I think we may not have any alternative but to go at the revenues in a way that we have not now. I would still hope we would not go at rates, but——

Mr. MOODY. Well, you are aware that we have made real defense cuts. We have held the Pentagon basically at levels of funding over the last 2 years——

Mr. RICHMAN. Yes, sir.

Mr. MOODY [continuing]. And that is not a small task, given the political momentum behind defense——

Mr. RICHMAN. I appreciate that.

Mr. MOODY. So we have made those cuts, and we have made 30 percent cuts, roughly, in the discretionary domestic area. We have not touched the entitlements, which I think probably is wrong because many of those are purely middle class transfers, one middle class to another. But we have not had the political will to go farther. Even Gramm-Rudman did not pretend to touch entitlements.

But we have made real cuts in discretionary and in military spending. So you are not worried, then, about fiscal 1988? You said basically, let the budget deficit go up.

Mr. RICHMAN. I am very concerned about the budget deficit, but I think it is a matter of taking care of it over a period of years, and I think we have got some things underway, including the Tax Reform Act, including the compliance people, including a continuous attack on spending, that will bring it down over time.

Mr. MOODY. I did not mean to cut into the other gentlemen's time. Mr. Jacobson or Mr. Caspersen, will you add a word or two.

Mr. CASPERSEN. I would agree, completely, with the comments made on that. I really think that equally important to the financial markets is the health of the infrastructure in America, and when somebody lays down the rules and says, this is where we are going, let's play by those rules for a little while because we can do it, and we can do it very well, whether it be nationally or internationally.

But let's not jerk the rule book out every 6 months and say, ahha, we need some more money, and all of your investments, all of your so-and-so that you have done under this really do not count, we are going to have to re-jigger the rules.

Mr. MOODY. That does not apply to excise taxes; it only applies to the income rates, right?

Mr. CASPERSEN. Well, the excise tax depends on what taxes you are doing, and how you are applying it, that is whose ox is gored. In some ways they do apply—I mean, look at the petroleum we just talked about. That affects competitiveness.

It is a complex situation, and we really cannot, for the health of the country's economy, change the rules every 6 months, 6, 2, or 3 years. If it does not work then let's go back, but give it a chance.

Mr. MOODY. Thank you. Mr. Jacobson.

Mr. JACOBSON. I would agree with my colleagues here.

Mr. MOODY. All right. So none of the three of you really buy this argument that the financial markets are going to treat it quite seriously if we fail to meet our own self preannounced budget targets, deficit targets.

Mr. RICHMAN. Yes.

Mr. MOODY. OK. Thank you.

Mr. STARK. The Chair is awaiting Mr. Pease who is returning from making the quorum. Do you want to go ahead?

Mr. MOODY. May I continue for a moment?

Mr. STARK. Please do.

Mr. MOODY. I was a little disturbed to hear you say you think taxes will just be spent. You know, in 1981 taxes went down and spending went up. We have been trying to recover from that hole we dug ourselves in ever since. I was not here in 1981 or 1982, but in fact we did restore taxes in 1982 and 1984, and if we had not done that, the budget deficits, by CBO estimates, would now be over $350 billion per annum, with God knows what kind of interest rates that that would carry, and international consequences.

In fact we have been catching up. The taxes have been following spending; spending has not been following taxes. We finally came to our senses in 1982 and 1984, and the President even signed bills that put back some of the revenues that were cut in 1982.

So, I feel we are getting into ideology when we assert that taxes will always increase spending. In fact taxes went down and spending went up, and we have been trying to climb out of that hole ever since.

The deficit, in 1986, was some 220 billion dollars. If we do not raise taxes on a purely current services basis, the deficit would be down—and I use the word in quotes—to $170 billion in 1988, by virtue of the 1982 and 1984 revenues. It is not that those revenues led to a binge of new spending.

Those revenues followed a binge in spending, as Congressman Dorgan said. We doubled defense spending and then we added $80 billion more to interest charges without the revenues, at first, to cover them.

Ever since, we have been slowly trying to catch up. I respect you gentlemen, tremendously, but when I hear you say, well, taxes will just lead to a new round of spending, that is not what has been happening in the last seven or eight years. Any comments?

Mr. RICHMAN. It is kind of a matter of assertion one way or assertion the other. It just seems to me that first of all history establishes that there is always pressure for spending, legitimate pressures, and secondly, that that pressure increases at about the time we are now, as we are heading into an election year.

And I would be very concerned, sir, that increased revenues, substantial increased revenues at this point might find their way into new spending programs rather than into a reduction of the budget. I would hope that if there are any new revenues that they would be used to reduce the budget, but——

Mr. MOODY. Would you buy a tax that was specifically escrowed for deficit reduction and off-limits for spending?

Mr. RICHMAN. I would prefer that. As I say, I would prefer to go the way we all outlined, but if there is to be a tax I would like to see it sequestered for application to the budget deficit rather than—of course, what goes in one side can come out the other, I suppose. I am not sure that——

Mr. MOODY. The money is fungible.

Mr. RICHMAN. Yes. Unless that were somehow or other a foolproof system, I do not know that it would work.

Mr. MOODY. But if the spending is locked in—and as you probably know, in the Senate—unfortunately not yet in the House—anything that exceeds the budget resolution is subject to a point of order on the floor by any Member. There are plenty of Members only too happy to lodge a point of order against a spending appropriation that exceeds the budget targets we have set for ourselves.

So I do not see that happening, unless by majority rule, we can pass some special appropriations over and above the budget limits, but in the Senate, at least, it is pretty easy to stop it. Any other comments?

Mr. STARK. If the gentleman will suspend, I recognize Mr. Pease.

Mr. PEASE. Thanks very much, Mr. Chairman. I appreciate your holding the panel until I got back from that vote.

Like other members of the committee, I would like to thank our panelists for their testimony. It has been excellent. I would like to ask one question.

Mr. Richman and Mr. Caspersen both, in their testimony, indicated that they and their companies have been supporters of the tax-reform effort last year.

Mr. Jacobson, your testimony does not comment one way or the other. Were you personally, or was 3M in support of the tax-reform effort last year?

Mr. JACOBSON. I was personally involved in the CEO Tax Group and our company was very much in favor of the Tax Reform Act.

Mr. PEASE. I thought so.

Mr. JACOBSON. Yes.

Mr. PEASE. Well, then, I asked the question because I did not want to leave you out of the praise. We did have your support in tax reform in 1985 and 1986 of a number of progressive corporate officials, and you three were among that group. I would just like to thank you on behalf of the Congress.

I believe that tax reform worked out extremely well, and we certainly could not have done it without the support of people like yourselves. I had met with some business people last week and pointed out that July 1 was an historic day for American business, the day that corporate tax rates dropped from 46 percent down to 34 percent.

Mr. Richman, I would particularly like to commend you for your support of Mr. Dorgan's proposals, and I would urge your col-

leagues at the table to join you in that support, and I hope very much that your CEO Group—is your CEO Group still in existence?

Mr. RICHMAN. Yes, sir.

Mr. PEASE. I would hope very much that you could work within the CEO Group to push that idea just as hard as you can. Mr. Dorgan's task force, which includes two former IRS Commissioners, has come up with some startling return numbers for investing about $3.5 billion.

We could pick up in 5 years about $105 billion, which would meet the targets of this budget resolution, and then some. It seems to me foolish for us to be considering raising income taxes, or excise taxes, or any other taxes, on Americans who are paying their tax bills, when there exists the possibility of collecting significant revenue from those who owe the money and are not paying it.

And I would say to you, sir, that we have an uphill battle within this committee, and in the Congress, but especially within this committee, to make use of the Dorgan proposals as a cornerstone of our efforts to raise $19.3 billion.

The difficulty is that the Joint Tax Committee, and the CBO, which do the scoring, and tell us whether we have met our goals or not, find it hard to assign specific figures to how much money could be raised or brought in from given amounts of extra appropriations for compliance and taxpayer assistance.

And to be honest, the position I have been trying to use with CBO and the Joint Tax Committee, is that I do not care how much they discount how much we can get in—they do not have to say $105 billion, they can say $50 billion or $25 billion, or whatever—but we will not get any place until they assign some figures. To me, it is clear that even by the most conservative estimates, there are revenues to be gained there, and I would hope that you might help us to apply the pressure from your own group to keep that possibility of enforcement and taxpayer assistance additions as a way of raising revenue.

Now that is a statement, not a question, but I just hope very much that you will do that.

I do have one question. All of you are urging us not to deal with the income-tax structure. I do not have any interest in changing the corporate tax rates we put in place. I think it would be a very large mistake for us to do that.

I do not have very much interest in changing the individual rates we have put into place, certainly not in a way that will affect the average taxpayer because I think there would be concern about a loss of credibility on our part.

I feel a little differently about the rate structure at the very high end. I know there is some desirable symmetry in the 15- to 28-percent bracket, but it is also true, that with the 28-percent tax bracket, even for the highest groups, we are going to give that particularly highest group a very, very large tax break compared to what the average citizen gets out of tax reform.

And it would be possible to raise significant revenue by changing the rates, only for joint filers earning more than about $180,000 a year. There would not have to be any change at all for people earning under $180,000 a year.

Now that being the case, I do not know how many employees each of you has who earns over $180,000 a year, but how strongly would you feel about "keeping the faith", so to speak, and not making any changes, even at that very high end?

Mr. RICHMAN. Congressman, I feel strongly about it. I think it is a part of the package. I really do. I think that this was a kind of a neatly crafted package, if you will, and there was "give and take", and a lot of people in the bracket you are talking about came down in favor of tax reform and supported tax reform because of the rates, and they traded off some very substantial preferences in many cases.

And I think what we have said throughout the morning really says that when you start—to me, the whole thing is like a ball of yarn. When you begin to unravel that package, I think the ball begins to unravel, and I would oppose any such approach.

Mr. CASPERSEN. I would echo that thought, and I would add the incremental thought, that your compliance idea, and Mr. Dorgan's compliance idea is extremely valid. It is even more valid because the entire compact was based on fairness, that each would pay his fair share.

And we have gone from an incredibly complex code to something, at least as applied to individuals, that makes some sense and can be enforced by people who do not have 20 years of training.

There are few brackets, there are not too many exceptions, and there are some overrides, that people try to get around it. If we start raising rates again for any group, you are going to raise the cost of compliance, and you are going to bring the tax practitioner industry back into full force.

Right now, you have something that is fair, something that is very close to a gross revenue test, as close as we can do and still satisfy basic tenets of fairness, and I would keep that.

I really think we have gone a long way, and, frankly, I think you will make more money, looking at this from an income standpoint for the Government, by having a very simple 28 percent gross revenue test.

It is simple to enforce. You look at it, and it is right there, and let's not get back into high rates, and what comes with high rates is invariably deductions, preferences, exceptions for the good of the country. You have heard that nomenclature over and over again.

Mr. PEASE. Thank you. Mr. Jacobson.

Mr. JACOBSON. I am in agreement with my colleagues here. We did change some of the basic rules of the tax system in order to get low rates. If you raised it on that top group, that would be, in a company like ours, a rather significant number of people and they are the decisionmakers. They are the people who are going to make it, you know, the kind of a company we want it to be, along with the help of a lot of others.

But these are the people who are going to make your decisions, who are making the economic decisions, and I feel they should not be disadvantaged compared to the other group, so far as the proportion of their income that goes into taxes.

Mr. CASPERSEN. One additional point that Mr. Richman reminds me of, is that we have changed our whole compensation scheme,

and I think my associates have done this also, into cash compensation for personnel.

Right now, what you get on the W-2 is what you earn. We have gotten away from all of the "goodies", the country club memberships, the cars, the perks here and there. Now we are dealing with real money and the Government is getting a share of that. So they are getting more.

And that is the way we would like to do it. It is up front, somebody knows what they are getting, they know where they are.

Mr. PEASE. Thank you very much. Thanks, Mr. Chairman.

Mr. GIBBONS [presiding]. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

Let me thank the panel for their excellent testimony this morning and further thank them for their help in forming an alliance for the passage of the tax reform bill last year.

I know, having sat in the room with each of you on a number of occasions, that there was some meeting of the minds as to what would be given away in terms of tax preferences vis-a-vis the reduction in rates, and I fully agree with you, and I will tell you that when the Speaker made the suggestion that perhaps they would put on hold the implementation of the second year of that two-part system reduction, there was not much stomach for it when we had the breakfast with the chairman some months back.

Let me address some of the things that have come up today, and then ask you a couple of questions as to perhaps what you think might be a violation of the compact that you thought that you had with us regarding tax reform last year.

First of all, the question on taxing those more heavily at the $200,000 level and above. I believe the distribution tables will show that those who make that kind of money, percentagewise, get a lower percentage reduction than those in the middle class, and lower class, even though perhaps the dollar amounts are somewhat higher.

There was a question here regarding advertising, whether or not 80 percent of advertising should be—or the Stark-Chafee approach, whether we should reduce the amounts or value of some tax preferences, and we have heard a lot, recently, regarding advertising.

Having been one who fought for a 100-percent deductibility of entertainment and business meal deductions, and doing that under the guise of believing that we should leave to businessmen, to themselves, to best decide the way that they want to do business, I cannot understand, frankly, why we should be allowing just 80 percent of an entertainment deduction while we allow somebody, perhaps somebody like yourself, to decorate your office for $50,000, or $100,000, or above, and allow that to be fully tax deductible.

I believe in trying to implement an 80-percent-advertising deduction, we would be doing a similar kind of thing, taking out of your hands the initiative, where you know how to conduct your business better than we do. So I would be opposed to something similar to that.

In regard to the compact that we all know we have regarding the rates, let me ask you whether or not you think that any change, or any reduction in any tax preference that presently exists, even after tax reform, is a violation of that compact?

Mr. RICHMAN. I think it probably is. I mean, I think that during the course of the birth of the Tax Reform Act of 1986, just about every preference was looked at, rates were looked at, tradeoffs were made, and, for example, the previous question about taxpayers at higher levels, for example, $200,000—in effect those taxpayers traded off a 20-percent capital gains rate.

So I think all up and down the line, Mr. Congressman, tradeoffs were made, and I think as soon as you begin to unravel that ball of yarn, as I said, I think it is going to keep coming.

Mr. MCGRATH. Well, I agree with you. I think the threshold was breached when we made the 80-percent business and entertainment tax an exception to that particular rule.

But understand that it was easy for us to come to an agreement on a lower tax rate. There were a lot of 18–17 votes on changes in preferences, and I think this is where we may have some differences of opinion among the members of the committee.

A suggestion has been made that a clean way, a simple way of collection of our burden of $19 billion—at least part of it—would be the implementation of a surtax over next year, or the following year, or the 3-year period that has been suggested in the budget.

Would you consider that to be a violation of the compact?

Mr. RICHMAN. Yes, sir. A surtax, to me, is just another increase in rate, and you may talk about it for 3 years, but when the end of that 3-year period comes, it is going to be viewed as an integral part of the tax structure and our spending will be based on it, and people will talk as if eliminating the surtax is some kind of a tax reduction.

Mr. MCGRATH. I understand your skepticism, having been one who voted for TEFRA in 1981 or 1982, being told that the addition of $100 billion in new taxes would equal a $300 billion reduction in spending which never occurred.

So, I understand your skepticism. How about you, Mr. Caspersen?

Mr. GIBBONS. The gentleman's time has expired.

Mr. MCGRATH. May I ask just Mr. Caspersen to respond to my question regarding the surtax.

Mr. CASPERSEN. I would prefer not having any surtax. I think we have a compact with the people to produce a broad-based tax at a certain level. We have taken away a lot of their deductions and we should keep it as an ongoing situation, give it a chance to work, and I think your revenue projections will be low.

Mr. MCGRATH. Thank you so much, all of you.

Mr GIBBONS. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

I have found your comments about how the tax reform bill is working to be encouraging, and I, as a supporter, congratulate you on your efforts to help make it happen.

I am somewhat less encouraged by your comments on how we handle the dilemma right before us. One of you mentioned, I think Mr. Caspersen, about time.

But as I see it, time is not the real issue. If there is the will, we have enough time. All three of you have mentioned the compact on tax reform, and it seems to me there is at least some form of com-

pact, keeping in mind, though, that everyone understood that the bill was being passed against the backdrop of a huge deficit.

And as to that, it seems to me there is also a compact, a compact to reduce the deficit, equally as solemn, if not more so, than embodied in the Tax Reform Act.

It was part of the pledge of the President when he ran for office, and this Congress—and the President signed it—passed a bill to take action against the deficit.

And you are very specific about the tax reform bill and what we should not touch, but when it comes to moving on the deficit, you are much more general. For example, several, or all of you have mentioned further cuts in programs, but you do not specify.

I take it that you are aware of the fact there have been substantial cuts in discretionary domestic programs in the last years.

I was tempted to give this report prepared by the Democratic Study Group to you and ask you to comment, but it might not be fair so let me ask you after you are done. In fiscal year 1981, 65 percent of Federal outlays were for domestic programs, 23 percent for defense. By 1987, the domestic share had dropped from 65 to 58 percent, and defense had risen from 23 to 28 percent.

When you look at the actual cuts, food stamps, you compare 1981 to 1987—now, this is in real dollars—a 13.5-percent cut; AFDC, 4 percent; housing, subsidized housing, 76.3 percent; mass transit, 41 percent; community development block grants, 36.3 percent; rural housing loans, 52.5 percent; the strategic petroleum reserve, 95 percent; and revenue sharing, 99.9 percent.

That is our dilemma. As you participated with us in the shaping of tax reform, it seems to me that people in your position will be most helpful if you will participate with us beyond the rhetoric that is swirling about this issue and talking with us about particulars. As Mr. Moody pointed out, not just to say not any more taxes will go for spending, we have a budget proposal that we are acting within. It is not a proposal; it is a binding resolution. And it is incumbent upon us to act.

We need and want your suggestions. Where do we act? What do we do? I think we should pursue Mr. Dorgan's idea to the hilt, but I do not think anybody here feels that we can attribute $19.3 or $20 billion to it this year.

So specifically, what do we do? I do not mean tiny specifics, but general specifics.

Mr. RICHMAN. Let me approach it from a different standpoint, because I think the spending point is still valid, Mr. Congressman.

The last year—and I think I am right on this—that the Government took in more money than it spent was 1969, and in that year taxes and spending were each at about 20 percent of GNP. This year, taxes are somewhere around 19 to 20 percent of GNP, and Federal spending is 24 percent of GNP.

That is the problem we see. Now, sure, recently there have been some cutbacks, but what has happened over time to unbalance the budget, if you will, is on the spending side. So I think it is still very valid for us to sit here and say that the chief target has to be spending.

Mr. LEVIN. But where? What should the increases have been in defense? Spending also includes higher interest payments, much higher interest payments? Be specific.

Mr. RICHMAN. Well, Congressman, with all due respect, sir, I am just not enough of a student of the situation to tell you where. It is as if I ask you to come in to Kraft and say where can money be spent. I think I know probably better than you do.

I am sorry. I just do not come with a program this morning to say so much from defense and so much from entitlements and so much from other spending programs. But I have found in my experience that when you have to effect cuts, you can do it.

Mr. LEVIN. Regardless? I mean, there is some limit, right, within——

Mr. RICHMAN. There has to be some limit within any organization. Have we reached that limit? I doubt it. I am sorry. I just do not have a program for you this morning.

Mr. LEVIN. My time is up. It would be helpful—and I mean this very constructively—if each of you could submit for the record some ideas as to where we would cut, going beyond the gross figures.

Thank you, Mr. Gibbons.

Mr. GIBBONS. Thank you, Mr. Levin.

Mr. Guarini.

Mr. GUARINI. No questions.

Mr. GIBBONS. Boy, that is good.

Let us see. Mr. Crane, Mr. Gregg, Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Let me commend the panel for their excellent testimony and their participation in the process. I know businessmen at times are often busy or do not recognize the necessity of being involved. So we doubly appreciate your willingness to come and testify and participate and help out. As you may have observed, from time to time we need some help and guidance.

Let me just bring the record up to date. I will not over-burden it, but there are some things that have been said that are not, I think, fully in tune with the record.

First of all, it has been observed, and accurately so, that we have doubled defense spending in this decade. That is entirely accurate. What was left unsaid is that domestic spending or, more precisely, nondefense spending, has more than doubled, and that two-thirds of our increase in spending this decade has been in nondefense areas, not in defense areas.

As one who has voted against the defense spending buildup, I find it somewhat strange to have people who voted for this defense spending buildup castigate our side of the aisle in that regard.

The figures are very explanatory. Taxes, revenue, have gone up more than 60 percent in this decade. They have not gone down; they have gone up 60 percent. Now, that is in current dollars; it is not in constant dollars. But in constant dollars, taxes have gone up and gone up significantly. Our problem is not an unwillingness to tax the American people. It has been an inability to say no to spending of any reasonable sort. Spending is up over 70 percent so far in this decade in current dollars.

It has been observed that we are locked in to our spending now with the budget. I would respectfully disagree with my colleagues who hold that opinion. There is not a single year in this decade that we have stayed within our budget once we have passed it. We have averaged over-spending our budget by almost $40 billion a year.

I am going to repeat that. We regularly overspend the budget and ignore it completely.

This committee itself has just recently passed out a $5.2 billion welfare increase bill that is all over budget; none of it provided for in the budget document.

Mr. MOODY. That is not true.

Mr. BROWN. Well, the revenue is simply not provided for in that measure.

I think when we look at this thing to say that we are going to stay within our budget does not comply with what Congress has done, nor with what I suspect it will continue to do.

It was also observed there were no real budget alternatives on the Republican side. Mr. Frenzel offered a budget in which I joined that met the Gramm-Rudman targets. The Democratic Rules Committee did not see fit to allow it to be offered, but there have been alternatives that are offered that do not increase taxes, that do meet budget guidelines.

I thought those items deserved to be mentioned because I think they are an important part of the debate. The fact is we have been unable to face up to spending matters, and the huge tax increases that we have had this decade have simply not been able to satiate the appetite of higher spending.

I would hope you gentlemen might shed some light on comparisons of tax rates in the places you have choices to put plants. Specifically, when you decide where to put a plant, how do the tax rates in the various countries that you are looking at compare? How does the United States stack up in terms of being competitive in terms of taxes?

Mr. JACOBSON. Well, Mr. Congressman, I feel under the current tax law, the Tax Reform Act of 1986, we are much more competitive than we were before. I think we were a high tax nation, as many other countries are.

It is very difficult to compare in some ways because in some countries the industries have a structure of debt which is considerably higher than ours; more money flows into interest and into combines of banks that own a lot of their industries. So it is very hard to track it. But we think that today we are very competitive, and we are starting to look at investments on a net aftertax earnings basis rather than on an operating income basis. I think that advantages the United States.

I think the United Kingdom has found already getting their taxes down has made a difference to them.

Mr. RICHMAN. I agree with that. I think that Mr. Jacobson referred before to other countries, Germany and others, that are looking very seriously at reducing tax rates. And I think that is a clear result of, among other things, our Tax Reform Act of last year that puts us in a much better competitive position.

Mr. BROWN. Do you find we are competitive in capital recovery provisions?

Mr. JACOBSON. I believe we are approximately equal. We can capital recovery in most jurisdictions.

Mr. BROWN. What about in terms of encouragement to export products, whether it is the gimmick, the practice of the Europeans and their value added tax?

Mr. JACOBSON. Here again, I do not think our Government has been particularly helpful in encouraging exports. I think we need to get rid of some of the gimmicks that our trading partners have, and I hope that Congress can take some action which will put some teeth in those regulations.

Mr. RICHMAN. I agree.

Mr. BROWN. Countries like Ireland and England have real tax incentives for exports in terms of special exemptions for people who are involved in export industries. Do those work? Have those been effective in your experience?

Mr. JACOBSON. Let me say in my experience, no, I do not think the situation in Ireland has been particularly productive because they have got quite a few plants that have come and gone. I think a long-term stable tax situation is by far the more preferable to gimmicks.

I do not think that every economy in the world can expect to survive on a high level of exports. We are the only major market that they have access to on that basis, and they are all trying to rape our markets.

Mr. BROWN. Thank you.

Mr. Chairman, I yield back my time.

Mr. GIBBONS. Well, that is generous. Thank you.

Mr. Gregg.

Mr. GREGG. Thank you, Mr. Chairman. I want to thank the panel for coming and being so patient. I especially want to thank Mr. Caspersen who was an aggressive supporter of the tax reform bill, had a lot of influence over many of the policy decisions I made, having had a chance to work with him and talk with him on those issues.

I appreciate the fact that you folks are self-supportive of the tax reform. And I am totally in agreement and concert with what you're saying today, that we should not go into this bill again; that we should maintain continuity and allow the marketplace to adjust to the new language, the new bill, and go forward and let the dust settle, as the phrase is used.

I think it's ironic that some of the members on the other side have used the terms "bite the bullet," that this committee is ready to bite the bullet by raising taxes. I wish we had been so aggressive in biting the bullet when we passed out the welfare bill, as Mr. Brown said, which created $5.7 billion of new spending, or the catastrophic health care bill which adds $25 billion of new spending, or even the trade bill which added new trade adjustment language, or that the Congress generally bit the bullet during the appropriations processes over the last few weeks when we failed to pass a series of fairly minuscule cuts in spending that may have redressed the deficit in some way.

I would note also that the budget which so grandiosely bites the bullet by raising $19 billion of new taxes and $64 billion over 3 years, cut spending by $4 billion. That's one two-hundredths of the entire budget. We can't find any more cuts than one two-hundredths of the entire budget? Sort of absurd.

It's clear that you folks agree with the basic philosophy that we should reduce spending and not increase taxes.

I was wondering, however, if there is any place where you feel that we could reduce taxes and generate more revenue, such as, for example, the capital gains issue? There's been a lot of debate on that issue, whether or not a reduction in capital gains rate would raise revenue because it would create more market activity, or by keeping the elimination of the differential were going to cause people to keep their assets longer and thus have a chilling effect on the turning over of assets and generating revenue.

And I would be interested for your comments on whether or not a return for differential and capital gains would have any effect on revenues.

Mr. CASPERSEN. I would like to use Mr. Richmond's analogy. As soon as you start unraveling the bolt of wool, the whole thing comes undone.

I personally liked the low capital gains rate. I know many of my colleagues did. I think there's a good argument for it. But there was a tradeoff, and none of us liked some of the things we gave up, but we got some things back. And I don't think we can equivocate on that.

We have a bill, I think a good tax reform bill. I think it's going to have a significant long range, positive effect on the country, and I think we should stick with all aspects, be they good or bad for a particular group or individuals.

We visited that and that was part of the tradeoff, and I don't think we can go back and revisit again. Though I did love that 20 percent rate.

Mr. RICHMAN. I subscribe to that. I like lower capital gains rate. I always thought dividend deductibility was an extremely important element in the increased growth and productivity of American industry. And maybe some day we can come back and revisit those things. But we made our deal, so to speak. People are now acting on the basis of that, and if we reopen it and try to get lower rates for those, we're going to have to come up with the money for it, I think, and we can't prove to you that the money will be there automatically.

So I would leave it alone. I'd say we have a vast improvement in our tax structure as a result of the Tax Reform Act of last year, and I'd give it a chance to work.

Mr. GREGG. Thank you.

Mr. JACOBSON. I would agree. I think a dollar of income should be taxed the same regardless of where it comes from.

Mr. GREGG. Thank you.

I yield back my time.

Mr. GIBBONS. That completes the examination of this panel.

Is there anyone who has been missed or overlooked or needs to ask another question?

If not, on behalf of all of us, we wish to thank you for coming here and helping us today with this problem. This committee must have loved you because I've never seen them keep anybody as long as they kept you. And I want to let you know, and I hope everybody will recognize, the fact that the men's room is right outside the door. [Laughter.]

Clear the way for these fellows.

Thank you very much.

OK. The next witness is the Tax Reform Action Coalition, Mr. Van Dongen.

And I would say to all of the folks here that we've got a long way to go today, gentlemen, ladies. Anything you could do to speed it up will be appreciated.

Mr. Van Dongen.

STATEMENT OF DIRK VAN DONGEN, PRESIDENT, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, AND COCHAIRMAN, TAX REFORM ACTION COALITION

Mr. VAN DONGEN. Mr. Chairman, members of the committee, good morning.

My name is Dirk Van Dongen. I am cochairman of the Tax Reform Action Coalition, and president and chief executive officer of the National Association of Wholesaler-Distributors. We appreciate the opportunity to appear here this morning.

You do have our written statement for the record.

Mr. GIBBONS. Yes, sir, and without objection, the entire statement will be placed in the record.

Mr. VAN DONGEN. Thank you, Mr. Chairman.

And with respect to your request, I would like to put my full statement aside and, instead, briefly describe TRAC and then make just four very quick points if I may.

The Tax Reform Action Coalition consists of over 250 associations and corporations. You have a full listing of the coalition's membership at the end of our testimony. All told, over 1 million plus businesses are represented in TRAC from small individual proprietorships to over 100 of the Fortune 500 industrial corporations.

TRAC was formed in June 1985 to support rate reduction driven tax reform. The coalition worked extremely hard throughout the tax reform process, as many of you know, to this end, and has remained in existence to protect implementation of the low rates.

Mr. Chairman, the four points I'd like to emphasize build to some very great extent on what you've already heard in earlier testimony this morning.

First, TRAC believes changing the rates set forth in the Tax Reform Act of 1986 would violate the very essence of the tax reform process. It would, in our view, shatter the compact, and that word was used repeatedly this morning, I might observe, which was forged with the American people just so recently. Changing the rates would be unfair.

These are strong statements admittedly, but ones which we believe meet objective scrutiny.

Tax reform was a rate driven process. Rate reduction was accomplished through base broadening. This committee made difficult choice after difficult choice in order to bring about rate reduction. And the result again, as has been observed, was a finely balanced package in which the specific rates arrived at took on a significance beyond that of the particular numbers involved.

I can think of no better illustration of this point than TRAC's membership itself. Many members of TRAC paid a substantial price in the reduction of their ability to utilize preferences. They did so knowingly in return for the reduced rates.

My second point, Mr. Chairman, is that tax reform was one of the most significant economic deregulation actions taken by Congress in recent history. You lessened biases in the code which subsidize certain economic activities at the expense of other economic activities, replacing them, instead, with lower rates in combination with fewer and weaker preferences. The result is the more efficient allocation of resources. You greatly strengthened the flow of capital to investments which made sense first from an economic point of view by your actions.

This will ultimately result in a much stronger American economy, a matter of fundamental significance obviously, given the immense challenges facing this economy today.

By making it clear that the rates will not be changed, you will, if you choose to do so, send a signal that you have reaffirmed that reliance on the marketplace to allocate resources is and remains a core value of tax policy.

Third, delay in the implementation of the rate reductions contained in the act is no less troublesome than a change in the rates themselves in our view. A delay will effectively deny the American taxpayer the very benefit which was the moving force which propelled the 1986 legislation to a successful conclusion.

Fourth, and my final point, the fact that a surtax is a rate increase cannot be escaped. Surtaxes should be rejected for this reason alone. But there's another reason also. Surtaxes do not have equal effect across the board. This is because, even after enactment of the TRA of 1986, different parties with the same financial income still have different effective tax rates depending upon the importance of the preferences which remain in the code and their use of those preferences.

Let me illustrate my point. Assume, if you would, two businesses, one with an effective tax rate of 20 percent, the other with an effective tax rate of 34 percent. A 10-percent surtax—and I use that number because it calculates easily for me—would increase the effective tax rate of the 20 percent firm to 22 percent. But that same 10-percent surtax would change the effective rate of the 34 percent firm to 37.4 percent. In other words, the lower taxpayer would see his effective rate rise by 2 points, while the taxpayer at a much higher rate to begin with would see his tax rate increase by 3.4 points, an increase which is 70 percent higher than that of the 20 percent firm.

Mr. Chairman, in conclusion, let me say that TRAC supported the Tax Reform Act of 1986 because of the rate reductions which are its lunch bed.

We strongly urge that the core value of lower rates be emphatically reaffirmed as you continue your deliberations.

Thank you, Mr. Chairman, for the opportunity again to be here.

I would be glad to answer any questions you might have.

[The statement of Mr. Van Dongen follows:]

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STATEMENT OF

DIRK VAN DONGEN, PRESIDENT
NATIONAL ASSOCIATION OF
WHOLESALER-DISTRIBUTORS

ON BEHALF OF THE

TAX REFORM ACTION COALITION (TRAC)

SUBMITTED TO
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON

POSSIBLE OPTIONS TO INCREASE REVENUES
IN CONNECTION WITH THE FISCAL YEAR
1988 BUDGET RESOLUTION

July 8, 1987

I. INTRODUCTION

Mr. Chairman, members of the Committee, my name is Dirk Van Dongen. I am President of the National Association of Wholesaler-Distributors and a member of the Management Committee of the Tax Reform Action Coalition (TRAC). It is in the latter capacity that I appear before you today.

II. THE TAX REFORM ACTION COALITION

TRAC was formed in June, 1985 by six business associations and corporations which were committed to enacting federal tax reform legislation which substantially reduced the then-existing high nominal tax rates. The Coalition's membership grew rapidly and, by the time the Act was signed by the President, TRAC was comprised of almost 250 individual corporations and associations. At that time, TRAC's membership included major major manufacturers of products ranging from cars to electronic devices to computers, food, clothing and petroleum products as well as major financial services and investment companies, major real estate developers, trucking companies, wholesaler-distributors, retailers, and a host of small businesses of all types. All told, the Coalition's original membership represented more than 100 of the FORTUNE 500 industrial companies and over one million businesses nationwide. In sum, TRAC's membership demonstrated widespread business community support for fundamental tax reform in an admittedly divided business community.

As the members of this Committee know, TRAC actively supported the adoption of H.R. 3838 both in the House and in the Senate as an improvement over prior law based on the bill's substantial reduction in marginal tax rates. Throughout the process, TRAC focused solely on the issue of tax rates and the Coalition retains that focus today.

Following the enactment of the bill and its signature into law, TRAC decided to remain organized as an action group to help insure, if necessary, that the rate reductions in the Act would be implemented and maintained. The suggestions to date to tamper with the lower rates -- whether by delaying their implementation, by increasing them, or by imposing a surtax -- unfortunately underscore that our decision was a prudent one. Significantly, TRAC's membership (list attached) is growing in response to these suggestions and substantially more businesses from all business sectors are now counted within the membership.

III. OVERVIEW OF TRAC'S POSITION

On behalf of TRAC, I would like to commend you Mr. Chairman, and this Committee for the role you played in the passage of the Tax Reform Act of 1986. The Ways and Means Committee did an extraordinary job of producing a bill under tremendous political pressure.

You face similar and perhaps even greater pressure this year in attempting to meet the reconciliation instructions in H. Con. Res.93, the Concurrent Resolution on the Budget for Fiscal Year 1988. Specifically, the requirement that you raise $19.3 billion in FY 1988, $22 billion in FY 1989, and $23 billion in FY 1990 imposes a heavy and unpopular burden on you.

IN ATTEMPTING TO DISCHARGE YOUR RESPONSIBILITIES, YOU HAVE A NUMBER OF REVENUE INCREASE OPTIONS AVAILABLE TO YOU. THE TAX REFORM ACTION COALITION URGES IN THE STRONGEST POSSIBLE TERMS THAT THIS COMMITTEE NOT TAMPER WITH THE RATE SCHEDULES, DIRECTLY OR INDIRECTLY, AS IT DISCHARGES ITS RESPONSIBILITIES UNDER RECONCILIATION. THOSE RATE REDUCTIONS ARE THE LINCHPIN OF THE '86 ACT AND SOUND AND SUBSTANTIAL POLITICAL, POLICY, AND ECONOMIC REASONS DICTATE THAT THEY BE IMPLEMENTED AND ALLOWED TO FULFILL THEIR PROMISE OF A FAIRER, MORE EFFICIENT TAX CODE.

IV. TAMPERING WITH THE RATES WOULD UNDERMINE THE PUPOSE OF TAX REFORM AND BREAK CONGRESS' PACT WITH THE AMERICAN PEOPLE

In testimony submitted to Congress early in the tax reform process, the Tax Reform Action Coalition made two specific recommendations concerning the development of a tax reform package which are pertinent to the instant discussion. TRAC recommended that:

1. Legislation which reduces top corporate and individual tax rates to the lowest possible levels should be the primary objective of the Committee's tax reform markup.

2. The economic benefits to be derived from significant rate reductions for corporations and individuals were too significant to be delayed or phased-in.

TRAC's testimony supported these recommendations on a number of grounds including:

- Major long-term economic benefits would be derived from substantial tax rate reductions. Substantially lower rates would loosen the tax law's grip on marketplace decisions and provide powerful and efficient incentives for sound investment and economic growth;

- The overall long-term economic benefit of substantial tax rate reductions would be a parallel reduction in

the impact which the heavy hand of high rates was having on the millions of business and personal financial decisions made each day. The rate of tax which a person expects will be imposed on the income from making additional investments or from providing more hours of personal labor affects his or her willingness to do that which is otherwise economically sound; and

- Within the context of overall tax reform, significantly lower tax rates for both individuals and corporations would reduce the disparities in treatment of taxpayers and put them on a more equal and competitive basis.

TRAC's statements in support of substantially lower marginal tax rates echoed the widely-held beliefs which led the President to recommend and the Congress to enact tax reform legislation.

As this Committee begins its deliberations, we believe it should ground its consideration of potential revenue increases in the origins of and the catalyst for the tax reform movement. While it has been claimed in some quarters that the rate cuts enacted by Congress just last year were neither a tradeoff for eliminating preferences nor part of a pact with the American people, the evidence suggests otherwise.

For example, the President, in transmitting his "Tax Proposals to the Congress for Fairness, Growth, and Simplicity," stated that:

> For too long our tax code has been a source of ridicule and resentment, violating our Naton's most fundamental principles of justice and fair play. While most Americans labor under excessively high tax rates that discourage work and cut drastically into savings, many are able to exploit the tangled mass of loopholes that has grown up around our tax code to avoid paying their fair share -- sometimes to avoid paying any taxes at all.

Moreover, the General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation (May, 1987), or the so-called Bluebook, which was prepared in consultation with this Committee and the Senate Finance Committee and which echoes the Committees' Reports, describes the rationale for tax reform and for rate reduction at length. Among other things, it points out that:

> Congress was concerned that many taxpayers found the prior law tax system unfair and overly-complex. Further, Congress believed that a number of features of the prior law tax system resulted in excessive interference in labor, investment, and consumption decisions of taxpayers.
>
> * * * * *
>
> The sharp reductions in individual and corporate tax rates provided by the Act and the elimination of many tax preferences will directly remove or lessen tax considerations in labor, investment, and consumption decisions. The Act enables businesses to compete on a more equal basis ....
> Bluebook at 6.

Later, the Bluebook adds that:

> The Act's most important measures in promoting the efficiency of the economy and in reducing the interference of the tax system in labor, investment, and consumption

> decisions are the dramatic reductions in personal and corporate tax rates.
> Id. at 9.

And that:

> The changes made by this Act represent a historic reform of the Federal income tax structure. By providing sharply lower tax rates to individuals and corporations, the need for special tax preferences is greatly diminished.
> Id. at 11.

Frankly, TRAC cannot state the case any better itself. We read the statements above to acknowledge that prior law was unfair and inefficient because it treated taxpayers unequally, thereby causing investment decisions to be tax-motivated rather than economically motivated. The way to cure the problem was to lower rates in return for broadening the tax base.

Moreover, TRAC's explicit and implicit understanding in working with this Committee, the Senate Finance Committee, and the Administration was always that tax preferences had to be exchanged for lower rates if the goals of reform were to be achieved. It is perhaps worth noting that in many cases the price of the exchange was extremely high for the business community generally and many original TRAC members specifically.

TRAC's support for tax reform was predicated in large measure on that exchange and the results it was intended to achieve. Should this Committee, the House or the Congress lose sight of the fundamental importance of the rate structure to the Act, the risk is run of undermining the purposes of tax reform and of reinstituting the unfairness and inefficiencies of prior law.

The Act's lower rates can hardly produce their intended effect if they are not permitted to go into and remain in effect. Many of the benefits of tax reform were projected as long-term. They should be given the chance to appear. The investment patterns and habits of three decades of high rates and special provisions cannot be changed overnight.

It would also be particularly unfair for Congress to tamper with the rates. Not only would the compact it made with the American people in the form of last year's legislation be shattered as a result, but some taxpayers would be adversely and disproportionately impacted.

Mr. Chairman, you yourself have frequently noted that the Act is not perfect, but it is the best that was politically achieveable at the time. We agree. However, we also urge this Committee to recognize that the Tax Reform Act of 1986 by no means cured all of the problems which led to the reform of the 1954 code.

As a result, disparities in tax burdens still exist and delaying or increasing the rates promised by the '86 Act will only exacerbate them. A delay or increase in the rates means one thing to a business paying a 34% effective federal tax rate and quite another thing to a business paying less.

V. A SURTAX CONSTITUTES NOTHING MORE THAN A RATE INCREASE AND IS MANIFESTLY UNFAIR

The logic for not delaying the implementation of or increasing the rates in the Act argues with equal force against imposing a surtax on those rates.

First, the imposition of a surtax is a rate increase and cannot accurately be described otherwise. Whether applied to post-tax credit liability, pre-tax credit liability or to taxable income, a surtax imposes a higher rate of tax then would otherwise be the case. Describing a surtax as "temporary" does not change its nature as a rate increase; a "delay" in the scheduled rate reductions would achieve the same effect. Consider the simplest examples. A 10% surtax applied to the 28% top individual tax rate in 1988 would be the same as increasing the rate 2.8%. For corporations, a 10% surtax on top of the 34% rate would be the equivalent of increasing the rate 3.4%.

Second, a surtax is an unfair rate increase because it would not affect all taxpayers equally. All taxpayers still do not pay the same or even similar effective tax rates. (An effective rate is commonly computed by dividing the amount of taxes actually paid by the amount of net financial income.) As a result, a surtax would disproportionately strike those taxpayers that pay the highest rates of tax.

An example illustrates the point. Take Taxpayer A with $1 million in net financial income for 1987. The credits, preferences and deductions which still exist after tax reform are largely unavailable to Taxpayer A and its effective tax rate for the year is 34%. Taxpayer B, which also has $1 million in net financial income, is relatively able to take greater advantage of the available tax-reducing mechanisms in the code and has an effective rate of 20%.

In this example, a 10% surtax would increase Taxpayer A's tax burden by 3.4% from 34% to 37.4%. Meanwhile, a 10% surtax would only increase Taxpayer B's burden by 2% from 20% to 22%. Thus, Taxpayer A has an increase almost double that of Taxpayer B -- and it is Taxpayer A who already has an effective tax rate 14 percentage points higher than Taxpayer B.

In short, a surtax would exacerbate disparity and unfairness. The relative "simplicity" of its imposition embodies a fundamental flaw that this Committee and the Congrses should reject since it would have the ironic effect of reversing some of the constructive results of the '86 Act.

VI. CONCLUSION

TRAC supported the 1986 Tax Reform Act because of the rates it contained and the promise they hold for economic growth and tax equity. In the name of that landmark legislation, TRAC strongly urges the Congress do no damage to those rates.

Over a two-year period, Congress labored forcefully to produce the 1986 Tax Act. Cynics insisted that it could never be done. Overcoming enormous odds, you did it. For TRAC, the idea of revisiting the rate issue would border on the mystifying. It would at once shatter the compact Congress just recently made with the American people in the form of last year's legislation and adversely and, more to the point, unfairly impact many taxpayers in a manner dramatically at odds with the spirit and purpose of the Tax Reform Act of 1986.

MEMBERSHIP OF
THE TAX REFORM ACTION COALITION (TRAC)

(Steering Committee)

American Bakers Association
American Business Conference
American Electronics Association
American Furniture Manufacturers Association
American Home Products Corporation
American Retail Federation
American Trucking Associations
Amway Corporation
Beatrice Companies Incorporated
Beneficial Management Corporation of America
Bristol-Myers Company
Cadillac Fairview U.S., Incorporated
Computer & Business Equipment Manufacturers Association
Consolidated Freightways Incorporated
Edison Electric Institute
Emerson Electric Company
Food Marketing Institute
Foodservice and Lodging Institute
General Mills Incorporated
General Motors Corporation
Grocery Manufacturers of America
Hershey Foods Corporation
Hospital Corporation of America
I B M Corporation
J.H. Jones Company
Kraft, Inc.
Levi Strauss & Company
Lucky Stores Incorporated
McDonald's Corporation
McGraw-Hill, Inc.
Merrill Lynch & Company
National Association of Chain Drug Stores
National Association of Manufacturers
National Association of Tobacco Distributors
National Association of Wholesaler-Distributors
National Federation of Independent Business
National Mass Retailing Institute
National Retail Merchants Association
National Soft Drink Association
National Tire Dealers and Retreaders Association
National Venture Capital Association
Philip Morris Incorporated
Pillsbury Company
Preston Trucking Company
Primerica Corporation
Procter & Gamble Manufacturing Company
The Quaker Oats Company
Ralston Purina Company
RJR Nabisco, Inc.
Roadway Services, Inc.
Sara Lee Corporation
Standard Oil Company of Ohio
U.S. Tobacco
Wine & Spirits Wholesalers of America
Winn-Dixie Stores Incorporated

(General Membership)

Air Conditioning & Refrigeration Wholesalers
Air Delivery Service Incorporated
Air Van North American
Altier & Sons Shoes Incorporated
American Association of Advertising Agencies
American Dental Trade Association
American Federation of Small Business
American Frozen Food Institute
American Jewelry Distributors Association
American Meat Institute
American Movers Conference
American Traffic Safety Services Association
American Veterinary Distributors Association
Amfac Incorporated
Appliance Parts Distributors Association
Arkansas Freightways
Associated Wire Rope Fabricators
Association of Footwear Distributors
Atkinson Transfer Incorporated
Aviation Distributors & Manufacturers Association
B. F. Fields Moving & Storage
Bass Transportation Company Incorporated
Bearing Specialists Association
Beauty & Barber Supply Institute
Bicycle Wholesale Distributors Association
Biscuit & Cracker Distributors Association
C. W. Transporting
Campbell Soup Company
Cargo Express Company Incorporated
Carlton Trucking Company Incorporated
Carolina Freight Corporation
Carr Truck Service Incorporated
Ceramic Arts Federation International
Ceramic Tile Distributors of America
Chilton Corporation
The Clorox Company
Columbia Motor Express Incorporated
Consolidated Papers Incorporated
Contractual Carriers Incorporated
Council for Periodical Distributors Association
Council for Wholesale-Distributors National Kitchen and Bath Association
Craig Transportation Company
Crawford Fitting Company
Criber Truck Leasing Incorporated
Crouse Cartage Company
Cyclops Corporation
D. L. Merchant Transport Incorporated
Dart Trucking Company Incorporated
Dayton Hudson Corporation
De Fazio Express Incorporated
Dobson Mover
Dominion Resources
Door & Hardware Institute
Eddie Bauer Incorporated
Edmac Trucking Company Incorporated
Electrical-Electronics Materials Distributors Association
Elmer Buchta Trucking Incorporated
Ex-Cell-O Corporation
Explosive Distributors Association
Farm Equipment Wholesalers Association
Federated Department Stores Incorporated
Federation of American Health Systems
Flat Glass Marketing Associaton

Fluid Power Distributors Association
Food Industries Suppliers Association
Friedl Fuel & Cartage Incorporated
General Delivery Incorporated
General Merchandise Distributors Council
General Nutrition Incorporated
Greenfield Transport Incorporated
Griffin Distributing
Hartford Dispatch & Warehouse Company Incorporated
Health Industry Distributors Association
Hewlett-Packard Company
Hobby Industry Association of America
Independent Medical Distributors Association
Institutional & Service Textile Distributors Association Incorporated
International Sanitary Supply Association
Irrigation Association
Jewelry Industry Distributors Association
K mart Corporation
Kemp Furniture Industries Incorporated
King Transfer Incorporated
King Van & Storage Incorporated
Krenn Truck Lines Incorporated
Lacy's Express Incorporated
Land Trucking Company Incorporated
Larmore Incorporated
Loctite Corporation
Materials Research Corporation
Matterson Associates Incorporated
The Maxwell Company
McCourt Cable Systems
McLauren Trucking Company
McRae's Incorporated
Metal Purchasing
Mid-West Truckers Association
Monument Builders of North America-Wholesale Division
Moore & Son Trucking
Music Distributors Association
National American Wholesale Grocers Association
National Appliance Parts Suppliers Association
National Association for Hose & Accessories Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Marine Services
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Plumbing-Heating-Cooling Contractors
National Association of Retail Druggists
National Association of Service Merchandising
National Association of Solar Contractors
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Writing Instrument Distributors
National Automotive Radiator Service Association
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Associaton
National Fastener Distributors Association
National Food Brokers Association

National Food Distributors Association
National Food Processors Association
National Frozen Food Association
National Industrial Belting Association
National Industrial Distributors Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Moving & Storage
National Paint Distributors
National Paper Trade Association
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Screw Machine Products Association
National Spa & Pool Institute
National Transportation Incorporated
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
NCR Corporation
North American Heating & Airconditioning Wholesalers
Odisco Transportation
Optical Laboratories Association
Outdoor Power Equipment Distributors Association
PACCAR Incorporated
Pace Maker Express Incorporated
Pennsylvania House
Pet Industry Distributors Association
Polar Transport Incorporated
Power Transmission Distributors Association
Priority Freight System Incorporated
Red Lobster Inns of America
Red Star Truck Lines
Safety Equipment Distributors Association
Safeway Stores Incorporated
Scaffold Industry Association
Shared Medical Systems
Shoe Service Institute of America
Snack Food Association
South Hills Movers Incorporated
Southern Industrial Distributors Association
Spring Service Association
Square D Company
The Talbots Incorporated
Textile Care Allied Trades Association
Tomahawk Services Incorporated
Toy Wholesalers' Association of America
Unifi Incorporated
United Pesticide Formulators and Distributors Association
W. H. Fitzgerald Incorporated
Wales Transportation Incorporated
Walgreen Company
Wallack Freight Lines Incorporated
Wallcovering Distributors Association
Ward Transport Incorporated
Ward Trucking Incorporated
Warehouse Distributors Association for Leisure & Mobile Products
Warren Trucking Company
Water & Sewer Distributors Association
Wheeler Transport Service
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association
Wilcox Trucking
Wood Heating Alliance
Zayre Corporation

Mr. GIBBONS. Thank you, sir.

Mr. Pease.

Mr. PEASE. Mr. Chairman, I have just one question.

Mr. Van Dongen, is it your group that sent out the half bottles of champagne last week?

Mr. VAN DONGEN. Yes, it was, sir.

Mr. PEASE. To celebrate the dropping of the corporate rate from 46 to 34 percent, right?

Mr. VAN DONGEN. To commemorate, Mr. Pease, the action of this committee and its colleagues on the Senate Finance Committee in enacting the lower rates contained in the Tax Reform Act of 1986. We wanted to congratulate you, sir.

Mr. PEASE. If the committee and the Congress do not tamper with the personal income tax rates this year, are you still prepared to send out the other half of that bottle of champagne later this year?

Mr. VAN DONGEN. Mr. Pease, as you know, we sent a split of champagne rather than a full bottle. That was quite purposeful.

We believe very, very strongly that the individual rates concurrent with the corporate rates are central to the achievement of tax reform, sir.

Mr. PEASE. In light of that then, do you have a position on the proposal to raise excise taxes on wine?

Mr. VAN DONGEN. No, sir, we do not. TRAC, as a Coalition, limits itself strictly to the issue of rates.

As you might appreciate, we are a pluralistic coalition. There are different stake holders with respect to different parts of the code and different options that are before this committee, and those stake holders will, of course, speak to their own interest.

Mr. PEASE. Thank you, sir.

Mr. VAN DONGEN. Thank you.

Mr. PEASE. Thank you, Mr. Chairman.

Mr. GIBBONS. All right. Mr. Levin and then Mr. Duncan.

Mr. LEVIN. Mr. Chairman, the order, Mr. Moody was here earlier.

Mr. GIBBONS. Oh, I'm sorry. Yes, he is.

Excuse me, Mr. Moody. You're before Mr. Levin. Excuse me. Thank you, Mr. Levin.

Mr. MOODY. That's OK.

I appreciate your testimony. You agreed that there should not be a rate change because of the compact.

Mr. VAN DONGEN. That is correct, sir, and because we believe fundamentally, as I mentioned in my testimony, that lower rates as a concept represent a better form of tax policy, better for the American economy because low rates allow the marketplace to allocate resources.

Mr. MOODY. Should we lower them some more then on that basis?

Mr. VAN DONGEN. Once again, there was a compact. I think the argument could be made within reason that further rate reduction could be examined at some point in the future, but that obviously is not the context as I understand it, at least, of this committee's deliberations at this point in time. And we respect the responsibil-

ity that this committee has before it. So I'm not advancing that, sir, no.

Mr. MOODY. How do you feel about the compact to reduce the deficit by $19.3 billion beyond what we have already agreed to on the cut side?

Mr. VAN DONGEN. Well, once again, sir, I think that this committee has received instructions. This committee has responsibilities under those instructions. We respect that.

We recognize that you have a very, very difficult task in front of you. What we are here to say is that as you approach that responsibility, do not do it in a manner which is contrary to the core values of the Tax Reform Act of 1986 so recently put forth by this committee.

Mr. MOODY. Well, basically, since we don't impose property taxes, we sort of have two options here. One is to touch income tax rates, which you're advocating against, and the other is to go to the excise tax. There aren't many other tax options that I can think of other than perhaps import fees, which is a form of excise tax.

Would you agree with that statement?

Mr. VAN DONGEN. I would make the observation once again that your task is obviously a very difficult one, and that there are only so many places that you can go to secure big numbers.

However, the committee has before it a set of options that range well over 250 pages. There is a tremendous amount of revenue that is involved if you were to add up all of those options. And we would only encourage as the Tax Reform Action Coalition that this committee, as it approaches those responsibilities, evaluate each of those options, sir, including the options, I might add, that you have mentioned with respect to whether they are inimical or not to the core values of the Tax Reform Act of 1986.

Mr. MOODY. So that's the sole criteria you would use, that you're advocating. You're not saying that we shouldn't be looking at other things, but the one message for us today is don't touch the rates.

Mr. VAN DONGEN. That is the message of the Tax Reform Action Coalition that I am here to bring, yes, sir.

Mr. MOODY. So you're basically advocating a negative, don't touch the rates. You're not advocating for any other specific combination of taxes?

Mr. VAN DONGEN. That is correct.

Mr. MOODY. But you would agree, I gather, that those taxes and those 200-plus pages fall into two basic categories: income tax related tariffs and excise tax related tariffs.

Mr. VAN DONGEN. I would accept your characterization as accurate. I have not been through every last page of those options. But if that is how you have described them, for discussion purposes I would accept them.

Mr. MOODY. I'm certainly prepared to be corrected, but I think that's basically how you could divide almost everything into that book into one of those two categories.

Would loophole closings be characterized as violating the 1986 compact?

For example, what about constructive taxation of capital gains at death?

Mr. VAN DONGEN. Let me, first of all, respond to the question on behalf of TRAC, again respectfully reminding you that my mandate, because the coalition's scope is limited strictly to the rate issue.

Were you to ask me to wear my hat as president of the National Association of Wholesaler-Distributors, I don't know that I would be able to take you much further in that our organization has consistently opposed tax increase solutions to the deficit. That is the policy which our board of directors has bound on me as their representative.

Mr. MOODY. Is not loophole closure a tax increase?

Mr. VAN DONGEN. I——

Mr. MOODY. We are talking semantics, I guess.

Mr. VAN DONGEN. I guess we are talking semantics. One man's loophole is another man's preference is another man's right. The committee is well familiar with that circumstance.

Mr. MOODY. Right. So are you advocating no tax increase whatsoever, then? Did I hear you say that, or wearing your nonofficial hat today you would say that?

Mr. VAN DONGEN. The Tax Reform Action Coalition does not have a position with regard to tax increases per se. It is a rate-driven coalition. In any case, sir, whether we would advocate them or not, it occurs to me once again that the committee is already over that bridge, as I understand the responsibilities you face.

Mr. MOODY. Right.

Mr. VAN DONGEN. We felt it important to come here today and emphasize very, very simply that there is a very strong and large coalition of businesses, large and small, across this Nation who care very, very deeply about the rate reductions, individual and corporate, contained in the 1986 act.

Mr. MOODY. OK. I appreciate your directness, and that is very helpful. Thank you very much.

Mr. VAN DONGEN. Thank you.

Mr. MOODY. I yield back any time that may be remaining.

Mr. GIBBONS. Thank you very much. We can use it all.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman, and also thank you, Mr. Van Dongen. Mr. Pease was referring to the champagne. I think you must have sent that only to the drinking members because I just checked with some of the minority and we did not happen to get any of the champagne. So we will have to get in on that.

Mr. VAN DONGEN. Mr. Duncan, if you did not, sir, that was an oversight that can be easily corrected. My apologies.

Mr. DUNCAN. Thank you. It is a little bit late now. We are not used to drinking champagne in Tennessee.

May I ask you at this point in time can you tell what effect the Tax Reform Act has upon the economy, particularly as it refers to the members of your association; for example, wholesalers and distributors?

Mr. VAN DONGEN. Well, first of all, I think we heard a very, very encouraging commentary in that regard from the three chief executive officers who testified in the first panel. With respect to my industry, I can tell you the following:

Our effective tax rate generally has been reduced. Bear in mind, however, that wholesaler-distributors have a very high effective tax rate to begin with, so that that reduction has brought them down, yes, but has not brought them into low effective rate brackets.

The typical wholesaler-distributor is a small- to medium-sized business. It depends almost exclusively on retained earnings for growth capital. They do not go to Wall Street and float financial instruments and what have you to bring capital into the business. The corporate rate has been in effect for a week, so it is very, very hard to say that there is documented evidence in terms of hard numbers. But I can tell you behaviorally I am hearing from my people the same types of sentiments that were expressed by the CEOs who spoke a little bit earlier.

That is to say, we are going to make our decisions more on the basis of economic logic, less with reference to tax consequence. We are going to provide incentives in real terms rather than through fringe benefit constructs designed principally to avoid, in many cases, the tax bite on income at higher rates. So I see behaviorally the same type of thing occurring and I would expect clearly to the extent that that takes hold over time—and it obviously takes time, as you know, for behavior to modify—that we will look back at the Tax Reform Act of 1986, as imperfect as it may be in certain dimensions to each of us individually, and say that by placing reliance back on the individual and back on the marketplace to determine economic behavior, we greatly strengthen the American economy. I see signs of that, early signs of that within my own constituency.

Mr. DUNCAN. Does that reflect in the investment patterns in plant equipment?

Mr. VAN DONGEN. Again, a little bit too early to tell, in the wholesale distribution industry at least. Remember that the lower corporate rate has only been in effect, again, for a week—it went into effect July 1—so that any activity would be anticipatory of that rate. I have no hard data on our industry. What I am describing to you is anecdotal, but I believe it is widespread, at least as a sentiment.

Mr. DUNCAN. Does it appear that if the economy does well those that supported tax reform are going to claim credit; if it does poorly, those who were opposed are going to assess blame? So regardless of what outcome the economy might be, the tax reform legislation is going to receive credit or blame?

Mr. VAN DONGEN. Well, there is a propensity, I guess, for us to blame or applaud Government policy, whether it, in fact, has a direct or less than direct impact on circumstance. That having been said, the Tax Code inextricably up to the Tax Reform Act of 1986 was judged, I think, by all of us to be activist in the sense that it was designed to condition behavior and, therefore, outcomes.

To the extent that the Tax Reform Act of 1986 has backed away from that proposition—I described it as economic deregulation, and I think that is a fair characterization—I think more of the monkey now is placed on the backs of the individual taxpayer for the consequences that occur.

Mr. DUNCAN. Thank you very much.

Mr. VAN DONGEN. Thank you.

Mr. DUNCAN. I liked your statement.

Thank you, Mr. Chairman. I yield back.

Mr. GIBBONS. Yes, sir. Thank you.

Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman, and thank you for your testimony.

On page 4 you point to the blue book and you say providing sharply lower rates to individuals and corporations to meet the special tax preferences is greatly diminished. You underline that and say that you cannot state the case any better.

Seeing your view of it, would it be inconsistent if the committee looked at further base broadening, looked at further tax preferences which perhaps the committee had discussed last time but had not pursued?

Mr. VAN DONGEN. Mr. Levin, I would like to answer that question, if I may, in my capacity with the National Association of Wholesaler-Distributors.

Mr. LEVIN. OK.

Mr. VAN DONGEN. Bearing in mind, once again, that TRAC strictly is a rate-driven coalition and takes no positions on any other matters.

You have, again, over 250 pages of options in front of you. Some of those options involve preferences. Our own organization would have a certain stake in some of those items, as each organization in the business community would.

Stepping away from that, I would say very simply that the tax reform process that was completed last year was not the final tax reform process of all time, despite the effort. Because of the challenges, it had certain imperfections associated with it. Each of us would probably have somewhat of a different set of imperfections.

I would suggest that the committee, as I have mentioned earlier, should look at every one of those options in terms of whether those options go against the grain of what we consider to be the core values of tax reform: Rate reduction, return of decisionmaking to the marketplace, less reliance upon tax policy to do that, those types of things. Evaluate each of those items in that respect, and then reach the hard decisions, if you will, that we know you're going to have to reach.

I hope that is responsive to your question.

Mr. LEVIN. I think it is.

Thank you very much, Mr. Chairman.

Mr. GIBBONS. Thank you.

Mr. Guarini?

Mr. GUARINI. Thank you, Mr. Chairman.

I certainly agree with you to the point that we should have certainty in planning in our taxes and that we should not change our marginal rates. Nonetheless, if we hypothetically have to assume that there should be additional income to lower the deficit, and we do have to make choices and can only look at our options, I think that you have evaded, really, the main point of the hearings here.

In your opinion, what is our greatest priority, if you are given the choice? To reduce our deficit or to hold to the current tax law that we have passed last year?

Mr. VAN DONGEN. I would say, sir——

Mr. GUARINI. What is most important to America today?

Mr. VAN DONGEN. OK. A fair question. I would say to you that the answer cannot simply be a one or the other, at least from my vantage point. I would like to put some words on it which I think might make what I am going to say a little bit more precise.

I think it is terribly important that we do not tamper with the rates, as I have said, in the Tax Reform Act of 1986. That is a different statement than saying that I think everything that is in the Tax Code today ought to be frozen exactly as it is. There are things, obviously, we would like to change to the betterment of our industry. There are things beyond that that can be used, as you are well aware, to raise revenue.

The deficit problem needs to be dealt with. That is a very high priority of the business community. It is a very high priority, I think, of the members of this committee.

Our view at NAW is that it can best be accomplished by spending cuts. In its wisdom, Congress has said this time around there should be a tax increase component to the deficit reduction we are going to bring about. That bridge has been crossed, in other words.

You have to, it seems to me, look at the code, sir, to raise the revenue. We are saying do not do it by abusing the core values of last year's act.

Mr. GUARINI. Well, we have wanted and tried very much to reduce the spending, and we have a world today that is a little different than the world of yesterday.

Our roads right now and our bridges are falling into disrepair. We have an AIDS epidemic in our country that is going to take a billion dollars and more and cause considerable health care costs. We have got more homeless people walking the streets and living over grates on sidewalks than ever before. We have got more single-parent families so our social structure is different than it was 20 years ago. The need for day-care centers and other social needs are present. And if we have a nuclear agreement, that will make a safer world, but it certainly is going to cost us more military spending for conventional troops and weaponry.

So we are really not dealing with the same world that we had before. People are demanding more health care because we have sophisticated technological advances that are made to extend the lives of people. So we are really dealing with the world of today and the demands of our society. We cannot statistically compare what percentage of GNP we spent in one era from another era because we are in a different world.

Recognizing the fact that we are in a real and a different world, and if there is additional moneys that have to be raised, you, sir, have to face that—as I do—as an American. We are not going to be able to say, "Just leave the Tax Code alone" and put our hat on and walk out the door. We have got the responsibility of saying if there has to be additional taxes raised, what would be the most palatable way of raising them. What would be best for our economy? What would be least inflationary? What would not displace jobs or target industries or affect sections of our country? So you have got a responsibility to tell us.

Now, would you want to raise taxes if you had to if it were the only way possible to reduce the deficit, or would you prefer to go on with the existing deficit?

Mr. VAN DONGEN. A personal answer.

Mr. GUARINI. Yes.

Mr. VAN DONGEN. As opposed to one on behalf of the Tax Reform Action Coalition.

Mr. GUARINI. It is hard choices.

Mr. VAN DONGEN. I would be prepared myself personally to revisit the spending issue first. That being said, sir, I realize that bridge is crossed, that debate for this year is completed, if you will.

Mr. GUARINI. Right.

Mr. VAN DONGEN. And once again, I think part of the problem in dialogue on this point is that philosophically we do not want to be over that bridge. However, we recognize that irrespective of philosophy, you are over that bridge. Therefore, we are here to address the issue of the wisdom and the propriety of meeting your responsibilities through rate increase, rate delay, surcharge, things of that nature.

Mr. GUARINI. And you would want it to be progressive, or would you rather have an excise tax——

Mr. VAN DONGEN. I could not make an observation one way or the other on that point.

Mr. GUARINI. Would you care if it is an excise tax, which is a regressive tax and hits poor people, or would you prefer to have a progressive tax that scales somewhat within our income tax rates but would hit the wealthier people?

Mr. VAN DONGEN. I would prefer personally to have neither.

Mr. GUARINI. Of course you would.

Mr. VAN DONGEN. But I think there are other options in the option papers which could be looked at. I am not prepared to advance specifics in that regard on behalf of either organization, however, that I represent.

Mr. GUARINI. You see, you pass around champagne, sir, but we have a beer pocketbook in America today. And we have got to decide: Are excise taxes better than a surtax? Should there be luxury taxes? Should there be a tax on advertising? And all the choices are very, very difficult choices.

Mr. VAN DONGEN. I respect that.

Mr. GUARINI. This committee has not taken one position or another, but I would suggest to you that the best way to go, if we had to go, would be to have a progressive tax that would be a tax on the people who can best afford to pay.

Mr. GIBBONS. Frank, I do not think this witness is for any taxes, so go ahead.

Mr. McGrath.

Mr. MCGRATH. I would not be either. I do not blame him.

Thank you very much, Mr. Chairman.

Mr. Van Dongen, I hope that split of champagne is worth less than $35.

Mr. VAN DONGEN. As a matter of fact, I might make the observation that the delivery charge was more than the value of the token congratulations that we were sending to the members of the committee. I hope that it was received in that spirit.

Mr. MCGRATH. I perhaps would like to take you down the same line I took the others regarding what might or might not be a violation of the compact that we all agreed to in establishing the low marginal rates, and in addition, having some tradeoffs regarding tax preferences.

Recognizing that it is probably politically impossible—it is impossible—to raise the marginal rates; the President would never sign such a vehicle, and I do not believe the majority of this committee would go along either. A surtax has been put out there as a clean, quick, fast, and collectible way of fulfilling that $19 billion liability—by the way, which some of us are somewhat skeptical of because of the $36 billion that was supposed to be for budget deficit reduction; $19 or $64 billion over 3 years is added to our liability as a committee to come up with, where we see in some cases a refinancing of REA which is supposed to be a savings of $7.2 billion, I suspect, for this year, but will cost an additional billion dollars a year for the next 18 years. We are somewhat skeptical on this side of that kind of arithmetic.

But I am wondering specifically on the surtax whether or not the Tax Reform Coalition would view that as a violation of the compact.

Mr. VAN DONGEN. Very much so, sir. We view a surtax as inescapably a rate increase, which is what it is. When you get finished, it means that the rate of tax at which you pay will be higher.

Mr. MCGRATH. I recognize that it would be a rate increase; however, all things being what they may, perhaps a limited one for deficit reduction.

Mr. VAN DONGEN. Could I make a further point on that, if I may, Mr. McGrath?

Mr. MCGRATH. Certainly.

Mr. VAN DONGEN. There is a second reason that we oppose a surtax, and that is because as long as you have different effective tax rates between taxpayers, the same surtax percentage will increase the tax rate, the effective tax rate of the parties involved, differently. A good part, at least on the business side, of what the committee accomplished with the Tax Reform Act of 1986 was a leveling of the playing field, a reduction of disparities in effective rates. A surtax broadens that disparity. That is another reason we oppose it.

Mr. MCGRATH. We recognize that it would tend to increase the effective rate of those who pay more and reduce the effective rate of those who do not.

Let me ask you regarding things like the entire accounting section of the Tax Code. If we revisited that and gained some money regarding closing some of what may or may not be perceived loopholes in the accounting section, would that be a violation of the agreement that you and I think we have on this bill?

Mr. VAN DONGEN. Not necessarily so; in some instances, perhaps. Again—and I am not trying to wiggle on your question—it would depend upon the specifics of the proposals involved.

I might also observe, without taking license, since I am before the committee, there are some things that have created administrative nightmares in the changes that were made last year, such as the inventory capitalization proposals, that we would welcome an

opportunity to parochially revisit when appropriate. I speak for NAW in that.

Mr. MCGRATH. Mr. Jacobson testified that an increase in excise taxes on certain petroleum products would be an effective increase in his tax liability. Would an increase in excise taxes for manufacturing purposes for those of you who are in the Tax Reform Action Coalition be a violation of the compact?

Mr. VAN DONGEN. Not being a representative of the manufacturing community, I personally do not have expertise to the question that you are asking. I would defer to my manufacturing colleagues for an appropriate response on it. I represent the wholesale distribution community.

Mr. MCGRATH. All right. I have no further questions of the witness, Mr. Chairman. Thank you.

Mr. GIBBONS. Thank you. We thank you, sir.

Mr. VAN DONGEN. Thank you, Mr. Chairman and members of the committee.

Mr. GIBBONS. Next we have a panel: The Chicago Board Options Exchange, Securities Industry Association, the American Council for Capital Formation, and a senior research associate for the Urban Institute; Mr. Chapman, Mr. O'Brien, Mr. Bloomfield, and Mr. Minarik.

Gentlemen, before we get started, let me say that without objection all the statements of this panel will be placed in the record as delivered. Mr. Chapman, we will hear from you first as soon as you get a chance to get a name tag and a seat.

STATEMENT OF ALGER B. CHAPMAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHICAGO BOARD OPTIONS EXCHANGE [CBOE], ACCOMPANIED BY J. GREGORY BALLENTINE, PEAT MARWICK MAIN & CO.

Mr. CHAPMAN. Mr. Chairman, I am Alger Chapman, chairman and CEO of the Chicago Board Options Exchange, the world's largest options exchange. I appreciate this opportunity to present the views of the CBOE on the proposed securities transfer excise tax referred to as a STET.

CBOE opposes the STET. Let me first correct the misconception that many people have about a STET. The tax does not just fall on the wealthy. It will lower the income of all investors, including middle income persons, and will affect employees' interests in pension plans. It will also lower the income of traders in securities markets.

Thus, it has an effect similar to an income tax, but a STET is not based on ability to pay. Indeed, the tax is due whether or not the transaction results in a profit. The majority of stock market transactions are made on behalf of institutions in which average Americans hold a substantial interest. It is not neutral. The tax itself will distort investment and portfolio decisions.

Further, a STET will reduce liquidity in securities markets, reduce the ability of participants in an options and futures market to shift risk from those who do not wish to bear risk to those who are willing to do so, encourage expansion of foreign securities markets at the expense of our U.S. markets, and add to the tax burden

on investments in the United States, thereby tending to raise the cost of capital.

I would also like to emphasize the broader context of the effect of a STET on the U.S. position as a leader in world financial markets. The STET is called an excise tax, a type of tax that is usually justified by a desire to discourage the use of the taxed good. Thus, proponents of an increase in the gasoline tax frequently argue that the tax will reduce gasoline consumption, thereby reducing our dependence on foreign oil. Proponents of an increase in the so-called sin taxes argue that the consumption of the taxed product can be harmful and should be discouraged.

I do not believe we need a STET because it would reduce the use of our financial markets. The U.S. financial markets are the envy of the world. Other countries continually seek to emulate our efficient and liquid markets. The preeminence of our securities markets is the key to our overall standing as a leader in world finance, but our leadership must not be taken for granted. Just as in other areas of economy, we face vigorous and growing competition from abroad.

While three of the countries with which we compete impose a tax similar to the proposed STET, those countries and others without a STET take other measures to encourage their financial institutions. In Japan, for example, capital gains on securities are not generally taxed as ordinary income, and the Government cooperates with and encourages the activities of major Japanese financial institutions. And in the United Kingdom, the Government drastically limits double taxation on dividends, and its Government, too, supports the industry in its expanded role in the globalization of world financial markets.

Leadership in financial markets should not be considered in isolation. Financial markets are central to the capital raising mechanism of our industrial economy. A STET will reduce liquidity in financial markets, raise the risk of investing in those markets, and directly lower the return from such investments.

These combined effects will raise the cost of capital for U.S. firms. One might ask at a time when our industrial economy is facing severe competition, why impose a tax that will restrict the ability of financial markets to provide the funds needed for investment and will raise the effective cost of that investment. Let us not forget that the interest equalization tax was a major reason why the Eurobond market was created offshore.

Mr. Chairman, for several years the exchanges and the securities industry have worked with this committee to devise a system of taxing traders in securities, options, and futures contracts. We did not always agree, but we worked together in good faith. Recently, the Congress decided to tax all capital gains as ordinary income, thereby affecting all investors as well as traders.

Now, a STET is proposed. A STET will lower the net income of all investors in securities markets, including middle income individuals owning shares in mutual funds, employees with their interest in pension funds, and others.

As such, the STET has an effect similar to an income tax, and it comes on top of the recent income tax changes. But the STET fails the criteria this committee used in making those income tax revi-

sions. It is not based on an ability to pay. It is based on the number of transactions undertaken, not the total income from these transactions. For a given sales price of a security, the STET has a perverse effect; it taxes a higher share of income the less the income earned on the transaction, and taxes a lower share of income the more the income earned on the transaction.

It is not neutral. It will tend to lock investors into their existing portfolios, preventing them from exchanging securities when non-tax-market factors make it desirable, and it will cause investors to seek investments not covered by the tax.

In summary, the CBOE opposes a STET because it will harm America's leadership in the financial world, reduce liquidity, and increase risk in our financial markets.

Thank you very much. I am accompanied today by Mr. Greg Ballentine of Peat Marwick.

[The statement of Mr. Chapman follows:]

STATEMENT OF ALGER B. CHAPMAN
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
JULY 8, 1987

I. Introduction

Mr. Chairman and members of the Committee, I am Alger B. Chapman, President of the Chicago Board Options Exchange (CBOE). I am accompanied by J. Gregory Ballentine, a principal with Peat Marwick Main & Co. The CBOE is the world's largest options exchange; options on 160 equity securities of major corporations and on the Standard and Poors 100 and 500 stock indexes are traded on the CBOE.

The CBOE appreciates this opportunity to express its views concerning a proposed securities transfer excise tax (STET). CBOE opposes such a tax. A securities transfer excise tax will:

(i) reduce liquidity in securities markets;

(ii) reduce the ability of participants in options and futures markets to shift risk from those who do not wish to bear risk to those willing to do so;

(iii) encourage an outflow of transactions to foreign securities markets; and

(iv) add to the tax burden on investment in the U.S., thereby tending to raise the cost of capital.

Further, while the proposed tax is nominally an excise tax, in fact it will lower the income of investors and traders in securities. As such, the tax has an effect similar to an income tax, but it completely fails the traditional tax policy criteria this committee has applied in the recent tax reform legislation. Specifically, a securities transfer excise tax:

(i) is not based on ability to pay; and

(ii) is not neutral in that the tax itself will distort investment and portfolio decisions.

II. The Role of Securities Markets in the Economy

II (a) Stock Markets. Before explaining the harm that can be done by a securities transfer tax, it will be useful to explain the economic benefit from securities markets including, in particular, options and futures markets. U.S. securities markets are central to the capital raising mechanism of our modern economy. Essentially, direct securities markets -- including, for example, the New York Stock Exchange, the American Stock Exchange, and the regional exchanges -- allow investors to invest in major corporations, while maintaining their liquidity. Without such markets, an individual who had invested in say, G.M., but wished to shift to an investment in IBM, would have to seek out two other individuals, one who had invested in IBM, but was willing to sell, and another who wished to invest in G.M. The securities markets and the many traders in those markets make such an investment switch much easier and, consequently, cause securities investments to be highly liquid. Increased liquidity makes investments less risky and thereby encourages investment. The overall importance of organized securities markets with the large volume of transactions that ensure liquidity is perhaps best appreciated by the difficulty one has in imagining a modern, highly capital intensive economy such as the U.S. economy without an active securities market. The two are so closely interrelated that they seem inseparable.

II (b) Options and Futures Markets. The role and importance of options and futures markets may be less well understood. A futures contract is a contract to buy or sell a product at some future date for a specified price. Essentially, futures contracts allow individuals who do not wish to bear risk with regard to future prices to shift that risk to someone else who is willing to do so.

For example, a business venture that must incur current costs bears the risk that the price of the product when it is sold will not be high enough to cover those costs and produce a reasonable profit. The business can shift that price risk with a futures contract to sell the product at a fixed future price. A related example applies to exporters. They can use futures contracts in foreign currency to shift the risk from currency fluctuations.

Options contracts are similar to futures contracts and they perform a similar risk shifting function. An options contract is a contract that gives an investor the right to buy a commodity or a security within some specified time period for a specific price (a call option), or the right to sell a commodity or a security within some specified time period for a specific price (a put option). Clearly a put option -- an option to sell a product at a specific price at some future time -- can perform a similar role to a futures contract.1/

In 1973, the CBOE began trading standardized options on equity securities. These are options to buy or sell a security (e.g., stock in a major corporation) at a given price. Now such options are traded on four other U.S. exchanges, the American Stock Exchange, the New York Stock Exchange, the Pacific Stock Exchange, and the Philadelphia Stock Exchange. Options and futures contracts for U.S. Treasury bonds, notes, and bills, as well as options on indexes of equity securities, are also now traded on these exchanges.2/

The trading of securities options and index options has allowed individual investors and portfolio managers -- managers for pension and insurance funds, for example -- to manage market, interest rate, and other risk in much the same way that business ventures and exporters can manage price and foreign exchange risk. For example, a portfolio manager can limit the risk that the price of a particular security will fall by buying an option to sell that security at a fixed price. As another example, an investor holding particular stocks may wish to hedge against the effect of a general decline in the stock market by buying a

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1/ In most modern options and futures markets, the commodities are not actually sold under the contract, but the contract is, in effect, settled, with the investor receiving the difference between the market price and the put price.

2/ An index of equity securities is an index of the price of many different securities. One of the most commonly traded indexes of equity securities is the Standard and Poors 500. An option on an equity index is simply the right to buy (call) or sell (put) the index at a specific price within some given period of time.

put option or selling a call option on a broad index of stocks.3/ Further, the risk that interest rates may rise or fall can be managed through transactions in interest rate products such as the Chicago Board of Trade's Treasury bond futures market.

What all of these options and futures markets have in common is that they allow individuals -- investors, exporters, businessmen, etc. -- who wish to avoid risk to do so. These markets do not create risk and, of course, they do not cause the underlying risk to disappear. The markets shift risk to speculators who are more willing or able to bear it. The risk shifting process can work effectively only if markets are highly liquid with a large volume of transactions so that participants are confident that they can establish or close out positions quickly. The liquidity is supplied by speculators and most importantly by market makers -- professional traders who, pursuant to exchange rules or custom, hold themselves out as willing to buy and sell on a continuous basis. The market makers frequently play the role of speculators, regularly assuming positions for hours or even minutes.

Recently the Board of Governors of the Federal Reserve System (the Fed), the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC), studied the effects on the economy of trading in futures and options contracts.4/

That study concluded, among other things, the following:

(i) "The primary economic purpose served by futures and options markets is to provide a means for those wishing to reduce their exposure to economic risks to do so." (p. I-8)

(ii) "The trading activities of speculators, as well as other market participants, add greatly to the volume of transactions in futures and options markets, thus increasing the liquidity of the market. And the increased liquidity makes it easier for those wishing to hedge to establish and close out quickly positions in the market and on competitive terms." (pp. I-10-11)

3/ While risk shifting is the primary role of these markets, indexes and options on indexes can serve another role. An investor may conclude that the stock market in general is going to rise. Rather than buying a number of different stocks, which may be difficult and costly to do quickly, an index contract can be purchased. Later, individual stocks can be bought and the index contract liquidated. This use of indexes has been very attractive to managers of large portfolios such as pension funds.

4/ "A Study of the Effects on the Economy of Trading in Futures Options" submitted to the Committee on Agriculture and the Committee on Energy and Commerce of the House of Representatives and to the Committee on Agriculture, Nutrition, and Forestry and the Committee on Banking of the Senate. December, 1984.

(iii) "One of the important economic factors provided by the trading of speculators is the enhancement of the liquidity of the futures and options markets in which they trade. By increasing the volume of bids and offers in the market, speculators make it easier for those wishing to hedge to establish and later liquidate such positions quickly and on competitive terms. And ... trading by speculators and other participants in futures and options markets also tends to add to the liquidity of underlying cash [e.g., stock and bond] markets." (p. II-24)

Clearly, a high volume of transactions and the resulting liquidity are key factors in the efficient functioning of securities markets. The high volume of short-term trading by market making specialists mediates disparities in buying and selling interests and permits the options and futures markets to continue to function as efficient risk shifting mechanisms at times when customer demand becomes uneven.

III. A Securities Transfer Excise Tax Will Limit The Economic Benefit of Securities Markets

As the above description of the role of securities markets emphasized, the benefits they provide arise largely from the liquidity of the markets and the high volume of transactions that promote liquidity. Stock markets provide investment liquidity ensuring that an investor in G.M. is confident that he or she may change easily to another stock or security investment without having to search out other individual investors willing to make the opposite trade. Liquid options and futures markets allow investors to shift risk, confident that they can alter their strategy quickly at competitive prices.

The securities transfer tax will reduce these benefits directly by decreasing trading volume, reducing liquidity, and causing investors to tend to be locked into their current portfolio. Potential sellers of securities will be locked in because the tax will reduce their net proceeds from the sale for any given pre-STET price of the security (i.e., the price inclusive of the STET). This effect on sellers -- causing them to hold rather than sell -- will tend to raise pre-STET prices and reduce the volume of transactions.

The tax will have a similar effect on many potential buyers. Buyers will be discouraged because, at some point in the future, they will become sellers of the securities they buy today and the tax will reduce their expected proceeds from the future sale. This disincentive to current buyers will tend to lower the current pre-STET price and to lower the volume of transactions.

The net effect on the pre-STET market price of securities is unclear since the supply effect tends to raise prices and the demand effect to lower them, but the effects on the after-STET receipts from sales and, most importantly, on volume, are quite clear. The tax will lower after-STET receipts and will lower trading volume. It is difficult to quantify these effects precisely. However, the Congressional Research Service has estimated that the securities transfer tax would cause about a 12.7 percent decline in trading volume.

The dramatic impact on trading volume that this tax can have clearly demonstrates that the tax is not neutral. The tax

will cause investors to structure their portfolios differently, to hold investments that they would otherwise prefer to trade, and to seek out any securities or other investments that are not covered by the tax. In direct contrast to a central goal of tax reform, the securities transfer tax will make taxes a major factor in portfolio investment strategies.

The most dramatic effect of the tax will be on those speculators, specialists, and market makers that engage in numerous short-term trades. These are the traders that provide the liquidity that is central to the efficient functioning of the securities market. The total effect of the securities transfer tax on a market maker can easily exceed the income tax liability on the market maker's trades. Consider a hypothetical trader that throughout the year has sales equal to three times the trader's portfolio. Suppose that the total pre-STET gain on the sale is 12%. The total STET is 3%, leaving a net gain of 9% which is subject to income tax.5/ The income tax on this 9% gain, assuming the trader is in the 28% income tax bracket, is effectively 2.5% (i.e., 28% of 9% is 2.5%) Thus, the transfer tax burden is well above the income tax liability for this hypothetical trader.

Clearly, the transfer tax must be a major consideration for anyone engaged in a significant amount of trading. The 1% rate can be very misleading. The tax is imposed on the full price of a sale, whether or not the sale generates any income, and even sales that generate a loss will be taxed. Indeed, as is demonstrated below, the effective rate of tax is negatively related to the income on a transaction. Since market makers cannot stay in business without making a profit and since a STET will be incurred on every trade they make, they will have to charge more for the trades they make. This will reduce the liquidity of the market. In recognizing that this tax is likely to reduce sharply the number of short-term trades, it is important to keep in mind the value of short-term trading. It is the almost continuous short-term trading of market makers that ensures the liquidity of the market. The investor that does not make frequent trades nonetheless values holding liquid assets. An illiquid -- or thin -- market is one with few potential buyers and sellers. Such a market is more apt to have volatile prices and is more risky. Short term traders fill out a thin market, providing greater price stability and reducing overall risk to an investor in the market.

The risk reduction that arises from a large volume of short-term trades is distinct from the risk shifting of options and future contracts. As the Fed, CFTC, and SEC study indicated, a large volume of trading in the options and futures markets provides investors with the assurance that they can close out

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5/ This assumes a 1% transfer tax, half of which is collected from the seller and half from the buyer. The convention of collecting part of the tax from the buyer and part from the seller does not alter the fact that the tax is a 1% wedge between the total price paid by the buyer and the amount received by the seller. Thus, a 1% STET is incurred for each sale, and since in the example sales equal three times the trader's portfolio, the total STET is 3% of the value of the portfolio.

or take positions at competitive prices. If few trades take place, any investor must recognize the risk that, when he or she wishes to sell a security, some other investors may also sell and potential buyers will be swamped, leading to a sharp fall in price. Market makers, who are willing to make a large volume of short-term trades, diminish this risk.

IV. International Implications of a Security Transfer Excise Tax

IV (a) International Securites Markets. With the growth in the volume of international trade, the huge U.S. trade deficit, and the transformation of the U.S. from a creditor to a debtor nation, improving U.S. competitiveness has become increasingly important. The major factors that determine a country's competitiveness are the skill of the labor force, capital formation, research skills, management skills, and other such factors. The tax structure probably does not play a major direct role in our overall competitiveness, but taxes can have some impact for better or worse, and the effect of a securities transfer excise tax is for the worse.

The clearest international impact of a securities transfer tax will be a shift of some transactions and some securities issues to foreign exchanges. It is true that some other countries have securities transfer taxes.6/ Presumably those taxes have encouraged the development of U.S. securities markets and, thereby, the role of the U.S. as a world leader in finance. Imposing a securities transfer tax in the U.S. will tend to reverse these benefits.

It should also be kept in mind that in those countries where a securities transfer tax is in effect, there are other tax rules that are relatively favorable compared to the U.S. rules. Nominal capital gains are fully taxed in the U.S., whereas in the United Kingdom, Germany, and Japan they are either untaxed or taxed at a rate less than that on ordinary income.

IV (b) The Effect of the Tax on Investment. Another way in which the securities transfer excise tax can harm the U.S. economy and our ability to complete internationally is through its effect on investment. New corporate investment is financed by issuance of new securities (e.g., stocks or bonds) or by increasing the value of existing securities through retained earnings. To the extent that investment is financed by issuance of new equity or debt securities, the tax has an immediate effect, since one percent of the value of the security issuance is taken in tax. Further, the expected return on the security is reduced because investors must take into account the probability that they will sell the security at some point in the future, triggering an additional transfer tax.

6/ The United Kingdom has a stamp tax that is similar to a securities transfer excise tax. West Germany and Japan also impose a similar tax, but generally at a much lower rate than that proposed for the U.S.

Investment financed by retained earnings is also affected by the transfer tax because the increase in stock value due to the retained earnings increases the future transfer tax liability when a transfer occurs. This means that, in effect, the after-tax return to an investor on an investment financed by retained earnings is reduced by the transfer tax.

To a certain extent, the effect of the transfer tax on the cost of capital and on the returns to investors is similar to the effect of an increase in the capital gains tax rate. The effect of the transfer tax is broader, and more arbitrary, because:

(i) the transfer tax is imposed on the initial issuance of a security, not just later transfers;

(ii) the tax would be imposed on a transfer, whether or not income is realized on the transfer; and

(iii) entities such as pension plans or university endowments that are exempt from income taxes would be affected by the transer tax.

In the short-run, the transfer tax will reduce the net return to savers in the U.S. economy and, thereby, exacerbate the tax bias in favor of consumption. In the long-run, this bias in favor of consumption will persist and it can be expected that the tax will raise the cost of capital and discourage investment. While the economic evidence seems to indicate that overall U.S. investment is not highly sensitive to effective tax rates or to tax induced changes in the cost of capital, there is undoubtedly some effect and, in the case of the securities transfer tax, the effect can only operate to reduce investment.

V. The Securities Transfer Excise Tax is Inconsistent with the Principles Used in the Tax Reform Act of 1986

From the foregoing it is clear that a securities transfer tax:

(i) will reduce investors' liquidity;

(ii) will increase many investors' risk;

(iii) will likely increase the volatility of securities prices;

(iv) will reduce U.S. investment; and

(v) will reduce the U.S. role in financial markets.

Although the magnitude of these effects may be uncertain, their existence is not and, as a result, it is only reasonable to ask why a securities transfer tax should be considered good tax policy.

While nominally an excise tax, the securities transfer excise tax is not a true excise tax like, for example, a luxury tax. The transfer tax is imposed on transfers of income producing or risk shifting securities. Ultimately the tax will lower the portfolio income for all types of investors. Thus the tax has an effect similar to an income tax. The tax should be evaluated using the same criteria that Congress recently

applied during the debate over tax reform. Specifically, it must meet the traditional tax policy goals of (i) being based on ability to pay, and (ii) tax neutrality. In fact, however, the securities transfer tax is completely inconsistent with these two criteria of a good tax system.

V (a) Ability to Pay. Frequently, there is a misconception that securities are held and traded only by wealthy individuals. This is not true and, as a result, the securities transfer tax will fall on low income persons as well as on wealthy individuals. The clearest example of this effect arises from the tax burden borne by pension funds. The tax will lower net income earned by pension portfolios and, thereby, will lower the retirement income of many middle income employees who ultimately own the pension assets. A similar effect will arise from the tax burden on transactions undertaken by insurance companies. Policyholders at all income levels will bear the burden of reduced net income on insurance reserves.

In addition to the indirect burden imposed on lower and middle income persons through their interests in pension funds and insurance reserves, other middle income persons will be affected more directly. Many elderly persons with relatively modest incomes own securities that they periodically sell to assist in financing their retirement years. This tax will fall on them. Middle income persons also trade directly in options and futures markets.

Many middle income investors who own shares in mutual funds will be affected by this tax because, even though these investors may not buy or sell fund shares, the fund itself typically will buy and sell securities or options and futures contracts. The tax on the funds's transactions will lower the return on the fund, causing holders of mutual funds to bear the burden of a securities transfer tax.

Those bearing the greatest tax burden will be those who make the most transactions, not necessarily those with the highest income or the most wealth. Market makers, whose critical role in providing liquidity was described above, will bear an especially high burden from a securities transfer tax.

The ability to pay standard requires that taxes be clearly related to income, i.e., to the ability to pay taxes. The securities transfer tax clearly fails this standard. The tax may be broadly and roughly progressive, but because it is based on the volume of transactions undertaken it is not closely related to income. Any given transaction is subject to the same transfer tax whether it yields income or a loss. As a result, for a given sales price, the transfer tax expressed as a tax rate on income is inversely related to the income earned on the transaction.

The table below shows four hypothetical transactions. All transactions involve the sale of a security for a total price (i.e., the price inclusive of the total STET) of $100. The basis of the security varies in the example from $50 to $99, thus the realized gain on the transaction varies from $50 to $1. The fifth column shows the STET expressed as an effective tax rate on the realized nominal capital gains. Clearly the tax has a preverse effect: the smaller the gain, which means the lower the income from the transaction, the higher the tax rate.

Sales Price Inclusive of STET	Basis	Gain	Total STET	STET Expressed As An Effective Capital Gain Tax Rate
$100	$50	$50	$1	2%
100	90	10	1	10%
100	95	5	1	20%
100	99	1	1	100%

V (b) Tax Neutrality. Along with ability to pay, neutrality is a criterion for a good tax. Ideally, taxes should not distort business and investment decisions, which should be based on market considerations alone. A securities transfer tax will have a significant distorting effect on business and investment decisions.

The clearest distortion of the securities transfer tax is the lock-in effect. Portfolio holders will tend to be locked in to their current portfolio even when market information makes it desirable for them to shift their portfolio. The tax acts as a penalty on changing investments.

The lock-in effect has a lock-out counterpart particularly relevant to options and futures markets and to risk shifting. An investor or portfolio manager with a given portfolio may become concerned that a particular stock has a risk of falling sharply in price. Absent the securities transfer tax, that investor might purchase a put option to hedge against such a price decline. The transfer tax, by effectively raising the cost of such a contract, may lock the investor out.

Lock-in and lock-out effects are not the only distortions caused by the tax. If the tax is not applied to all securities -- and "all securities" is a difficult thing to define given our modern innovative financial markets -- it will bias decisions in favor of untaxed securities.7/ For example, if equity securities are subject to tax, but debt instruments are not, the tax will add to the tax system's bias in favor of corporate debt issues relative to equity issues.

Even if the tax is applied to both debt and equity securities, it will bias decisionmaking. Absent the tax, a firm might prefer to rely on short-term debt instruments that have a lower interest rate, but may need to be rolled over periodically. Since the tax would apply to each reissuance of short-term debt, it will encourage reliance instead on long-term debt. This bias is a kind of lock-in on the liability side of a firm. Application of the tax to debt instruments will also affect savers' decisions. They will tend to invest less in corporate bonds and other debt securities and instead place their funds in bank deposits.

7/ Indeed a further question is whether the tax should be limited to debt instruments traditionally considered securities, or whether other evidences of indebtedness, such as privately placed debt, short-term commercial paper, certificates of deposit, etc., should be covered.

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Clearly the transfer tax is not a neutral tax. It will bias investment decisions causing investors and portfolio managers to be less flexible in adjusting to new market information. This will cause portfolios to be more risky and less valuable than they would be if investors and portfolio managers were able to respond to market developments and market signals undistorted by tax considerations.

V (c) Congressional Action Revising the Taxation of Income From Securities and the Income of Security Dealers. Congress has spent several years, culminating in the Tax Reform Act of 1986, revising and improving the income tax system and, in particular, the taxation of income from securities and the taxation of traders in securities. While this process was very controversial, it was an attempt to apply the standards of ability to pay and neutrality -- standards the securities transfer tax clearly fails -- to our tax system in an objective manner.

Congressional action has resulted in dramatic changes in the taxation of the income from securities and securities traders. Though the securities and options industry had reservations about the decision, Congress decided to tax all nominal capital gains as ordinary income. As a result, securities holders are fully taxed on their realized nominal capital gains.

The taxation of traders in securities, particulary market makers in options and futures contracts, is a complex and difficult problem. Over a period of several years, the securities and options industries have worked with Congress to devise a system of taxing such traders. In 1981 traders in futures markets were required to mark to market their positions at the end of the tax year. In 1983 the industry made a proposal to extend this mark to market requirement to options traders, and in 1984 it was extended to those traders.

When the mark to market requirements were put in place, 60% of the gains resulting from marking to market were taxed as long-term gains and thereby subject to a 60% exclusion. The remaining 40% were taxed as ordinary income. With the elimination of the long-term gain exclusion in the Tax Reform Act of 1986, all income resulting from marking to market is now taxed at the same rates as ordinary income.

These changes in the tax treatment of investors and traders in securities have been the result of extended analysis -- analysis that sought to apply objectively the standards of ability to pay and tax neutrality. The securities transfer tax clearly violates the very standards Congress has used in the dramatic tax changes enacted for the securities industry.

VI. Conclusion

The securities transfer excise tax is not based on ability to pay and is not neutral. It will decrease liquidity in securities markets, increasing the riskiness of investments in securities and potentially leading to greater volatility in prices. It will also harm the role of the U.S. as a leader financial markets. In the view of the CBOE, Congress should reaffirm its commitment to basic tax principles and reject the securities transfer excise tax.

Mr. GIBBONS. Good. Well, Mr. Chapman, we commend you for concentrating a very complicated subject into the 5 minutes there.

The Securities Industry Association, Mr. O'Brien.

STATEMENT OF EDWARD I. O'BRIEN, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. O'BRIEN. Thank you, Mr. Chairman and other members of the committee.

I am Edward I. O'Brien, president of the Security Industry Association [SIA]. Our organization has often come before the Committee, and we want to thank you for the opportunity for being here today.

Our carefully considered opinion is that a securities transaction excise tax, a STET, would jeopardize the U.S. position as a premier world financial nation. Therefore, we do not think you should proceed with it if you have that in mind. It would strike at the savings and investments of millions of Americans of modest means. It would skew investment decisions, and it would discourage capital formation. There are a number of arguments against a securities transaction tax.

The proposal would affect millions of investors because ownership of stocks in the United States is today very broad based. Individual investors in treasuries, municipal bonds, corporate bonds, time and savings accounts and money market funds would also bear the burden of a STET.

Wealthy investors who do not move their transactions abroad will pay a transaction tax, but more importantly, so will the majority of America's 47 million individual shareholders whose income is under $40,000. Millions more will be taxed indirectly through their pension plans and increased insurance premiums and State and local taxes.

Money has always been fungible, but technology has escalated the internationalization of financial markets. Last year, foreign purchases and sales of U.S. equities totaled $275 billion, and U.S. investors bought and sold over $100 billion of foreign stocks. With the internationalization of securities markets and the sensitivity of investors to transaction costs, this proposal will force some transactions into foreign markets, reducing any revenues derived from the tax. Transactions have already been diverted by transactions taxes in certain other nations, including West Germany and England.

Moreover, many foreign countries with transaction taxes do not tax capital gains on stock investments. Japan, Italy, the Netherlands, and Belgium do not tax capital gains at all, and West Germany exempts long-term gains.

A seemingly small one-half of 1 percent transaction tax will quadruple transaction costs for institutional investors and double costs for individuals. Under STET, tax considerations will become a major factor in investment decisions and an impediment to market efficiency. This is directly contrary to one of the principal goals of tax reform undertaken last year.

The tax will also increase the cost of equity and debt financing for corporations and governments. For individuals who realize gains, the tax comes on top of a 40-percent increase in capital gains

rates. Those who sell at a loss would also be taxed since the tax applies to all sales.

Application of a transaction tax forces a choice between discriminating against capital formation or taxing people of very modest means. If the tax applies only to securities, then other assets and savings vehicles are given an edge by the Government.

On the other hand, a neutral application would tax millions of Americans who have interest-bearing savings and checking accounts. In short, a transaction tax raises more problems than revenues.

There are several other provisions in the options book in which the SIA has an interest. First, reimposing a foreign withholding tax on interest could lose more revenue in increased Treasury borrowing costs and higher interest deductions than it would generate in taxes.

Next, the proposal mandating further reductions of the dividend receipt deduction will increase triple taxation: twice at the corporate level and, of course, again to the individual. And it will cause corporations to rely even more heavily on borrowing than on raising equity.

If these proposals are flawed, there is a proven revenue raiser. Historical experience demonstrates that the reduction of capital gains taxes not only spurs investment in capital formation but increases tax receipts.

This committee retained a capital gains differential in its version of last year's tax bill. We suggest you consider restoring a differential now.

Mr. Chairman, we have tried in the interest of time to select certain parts of the options report for our presentation today. The SIA is continuing to review these options, and we look forward to working with the committee as it considers various alternatives in the coming weeks.

Thank you.

[The statement of Mr. O'Brien follows:]

STATEMENT OF THE
SECURITIES INDUSTRY ASSOCIATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JULY 8, 1987

Mr. Chairman and members of the committee, I am Edward I. O'Brien and I appear here today as President of the Securities Industry Association. I appreciate the opportunity to participate in the committee's hearings on revenue increase options.

SIA represents over 500 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types--investment banks, brokers, dealers, and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America. Because of their role in the capital markets, SIA members are in a position to recognize the impact of tax policy on the investment decisions of corporations and investors.

The Securities Transaction Excise Tax

A securities transaction excise tax (STET) would jeopardize the U.S.'s position as the premier world financial nation, strike at the savings and investments of millions of Americans of modest means, skew investment decisions, and discourage capital formation.

Historical experience and economic analysis argue against the implementation of a STET.

International Competitiveness in Financial Services

The internationalization of financial markets has escalated in the 1980s. In 1980, foreign gross transactions (purchases and sales) in U.S. equities totaled $75.2 billion. This activity reached a staggering $275.3 billion in 1986.1/ The momentum continued through the first quarter of 1987, with foreign gross transactions reaching $113.0 billion. U.S. investors have reciprocated. In 1980, U.S. investors' gross transactions in foreign stocks totaled $17.9 billion. In 1986, U.S. investors' purchases and sales of foreign stocks grew to $101.3 billion. In the first quarter of this year, U.S. investors' gross activity in foreign stocks climbed to $40.2 billion.

It has been observed that London's "Big Bang" is the first cannon shot fired in the battle for supremacy in international financial markets. Following the U.K., Canada undertook a major deregulatory program in 1986 and France has recently announced proposals aimed at making its market more competitive. Other nations have recently announced similar liberalization programs.

The "Big Bang", the "Little Bang", and the proposed "Le Petit Bang" have, in part, been prompted by recognition of the

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1/ We estimate that foreign activity accounts for 10%-12% of public volume on the NYSE.

huge amounts of capital available for both domestic and overseas investment. Just as foreign brokers and banks have established branches and subsidiaries in the U.S., U.S. brokers have already taken, and will be taking further, advantage of deregulatory measures in foreign countries by establishing additional offices in these market centers. Spurred by modern technology, competition in the securities industry has intensified and expanded to include foreign markets as well as domestic ones, a development that would not have been possible a decade ago.

U.S. companies are increasingly listing on foreign exchanges. A securities transactions excise tax will provide added incentive for overseas listings. Over 400 U.S. companies are now listed on four of the world's major foreign exchanges. Likewise, foreign companies have sought access to U.S. investors. The success of U.S. overseas mutual funds, 29 in 1983 and 74 in 1986, as well as the recent spate of "country" funds, attests to the continuing trend toward global markets. Combined NYSE, AMEX, and OTC listings show 281 foreign company equity issues and the ADRs of another 109 companies at year-end 1986.

Money has always been fungible. Today's technology has served to emphasize the speed at which money can move from one center to another without regard to geographic borders. The imposition of a transaction tax will send investors, both foreign and domestic, "shopping" for markets which offer the lowest transaction costs. For example, there is currently no transaction tax in Canada and depositary receipts, including those of American companies, are not subject to the U.K. stamp duty tax.[2/] Foreign investors, who made net purchases of an annual record-shattering $18.2 billion of U.S. equities in 1986 and a quarterly record-breaking $9.8 billion in the first quarter of 1987, would no doubt turn to more familiar markets if the cost of transactions increase in the U.S.

Some major foreign markets have a type of transaction tax. The diversion of trading to other markets caused by such a tax has been noted. For example, German bankers believe that the Boersenumsatzsteuer, the West German stock exchange tax on secondary market transactions in shares and bonds, has been the prime cause of the development of healthy secondary markets in West German stocks in foreign centers like London and Luxembourg.[3/]

The U.K.'s transaction tax, the stamp duty, is payable by the purchaser only. While the rate has varied over the years, in conjunction with the "Big Bang", this tax was reduced to 1/2%. It has been observed that there has been a substantial pick-up in turnover on the U.K. exchange attributable to the reduction of the tax as well as deregulation.[4/] For example, reported trades on the London stock exchange increased some 85% in the November 1986 - May 1987 period from the January - October 1986 period. (History: 2% (1957) to 1% (8/63) to 2% (5/74) to 1% (4/84) to 1/2% (10/86).) In comparison for the same period, reported trades on the NYSE increased 9%.

In 1985, the Bank of England published a research paper

2/ Newly created depositary receipts will be subject to a one-time 1.55 U.K. stamp duty reserve tax, an expanded version of the stamp duty instituted in October 1986. As of June 1986, about 195 U.S. companies were listed on the London stock exchange.

3/ "German bankers urge tax repeal", Financial Times, 3/6/87.

4/ Turnover is defined as the volume of shares traded as a percentage of total shares listed on an exchange.

which explored the effects of the stamp duty on the U.K. stock exchange.5/ The main reason for undertaking the study was the London market's lack of growth in turnover per stock. "[London's] Turnover as a percentage of market value was similar to that in New York in 1974, but over the past decade it has remained around the same level while the figure for the NYSE has almost trebled".

After concluding that the holding patterns of U.K. stocks (institutional versus retail) did not explain the lack of growth of turnover, the study examined transaction costs for the NYSE and Tokyo, NASDAQ and London exchanges and concluded: "Clearly, London is at a disadvantage compared with its major competitors." The results of the econometric simulations in the paper showed that the Stamp Duty had a significant dampening effect: halving of the rate of tax would increase the volume of transactions by 70% and share prices by 10%. As noted in the preceding page, London has experienced a 85% increase in reported trades which is supportive of this conclusion.

A securities transaction tax, in addition to the significant capital gains tax rate in the U.S. would put our domestic markets at a distinct competitive disadvantage. Many foreign countries with transactions taxes do not tax capital gains on portfolio stock investments.6/ Among ten major foreign countries, Belgium, Italy, Japan and the Netherlands do not tax capital gains at all, and Germany does not tax long-term gains (holding period of six-months).

Compared with the five countries taxing long-term gains, the U.S. treatment of capital gains is among the harshest of the major industrialized countries. Canada, France, and Sweden tax long-term capital gains at rates ranging from 16% to 18%.

Table I

Comparison of Individual Taxation of Capital Gains on Portfolio Stock Investment in Industrialized Countries

Country	Maximum Short-Term Cap. Gain Tax Rate	Maximum Long-Term Cap. Gain Tax Rate	Period to Qualify for Long-Term Gain Treatmt.	Maximum Annual Net Worth Tax Rate
Untied States 1987(A)	38.5%	28%	More than Six Months	None
Industrialized Countries				
Australia	50.25%	50.25%	One Year	None
Belgium	Exempt	Exempt	None	None
Canada(C)	17.51%	17.51%	None	None
France(D)	16%	16%	None	None
Germany(E)	56%	Exempt	Six Months	.5%
Italy	Exempt	Exempt	None	None
Japan	Exempt	Exempt	None	None
Netherlands	Exempt	Exempt	None	.8%
Sweden	45%	18%	Two Years	3%
United Kingdom(F)	30%	30%	None	None

Source: Arthur Andersen & Co.
Note: Based on exchange rates on March 31, 1987. State, provincial and local tax rates not included.

5/ "The effects of stamp duty on equity transactions and prices on the U.K. Stock Exchange", Paper No. 25, Bank of England, October 1985.

6/ Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock Investments in Seventeen Countries, Arthur Andersen & Co., April 1987.

(A) As of January 1, 1988, the maximum short-term capital gains tax rate is 28%.
(B) The above maximum short- and long-term rate are comprised of 1.25% Medicare Levy and 49% Income Tax. Prior to July 1, 1987, the Medicare Levy will remain at 1.145% and the Income Tax will remain at 57.08% (aggregating 58.225%). Long-term capital gains qualify for special exemption and inflation indexing of the cost basis.
(C) Canadian residents are allowed an annual capital gains exemption of $22,998 (Canadian $30,000) subject to a cumulative exemption of up to $383,300 (Canadian $500,000) by 1990.
(D) Gains from proceeds of up to $45,288 (FF 272,000) are exempt from taxation in a given taxable year.
(E) The first $554 (DM 1,000) of short-term capital gains is exempt from tax.
(F) The first $10,096 (£6,300) of gain is exempt annually.

While Australia and the U.K. have higher statutory long-term capital gains tax rates than the U.S., substantial exemptions and indexing of the cost basis result in more favorable tax treatment of capital gains by these two countries than in the U.S.

Four of the industrialized countries reviewed exempt short-term capital gains from taxation. Australia and Germany have higher short-term capital gains rates than the U.S. However, as explained above, Germany exempts long-term capital gains and Australia has liberal provisions which favorably affect the overall taxation of capital gains.

Signs of globalization multiply on an almost daily basis. The mere fact that exchanges continue to look for international linkages, such as the Toronto/Amex link, suggests markets are no longer only domestic. Many countries are undertaking major deregulatory programs in efforts to ensure their position internationally in financial services. For example, Toyko has allowed six foreign firms to have seats on the stock exchange. France has recently announced its plan to internationalize the Paris stock exchange by opening its tightly controlled membership to foreigners.

As global competition intensifies in financial services, increasing transaction costs through taxation would jeopardize the U.S.'s international position.

The Fat Cats?

There is a misconception that only the wealthy own securities. At the end of 1986, households had $3.3 trillion or about 37% of their financial assets in securities -- Treasuries, municipal bonds, corporate bonds, etc.1/ Well over half, 56%, of the securities holdings of individuals is invested in corporate equities. The NYSE's profile of the average investor dispels the myth that only the wealthy have stock holdings. More than 47 million Americans own stock directly. The average shareowner is 44 years old, has a household income of $37,000, and a portfolio of $6,200. The typical new or first-time investor shares a similar profile and starts out with a portfolio of under $3,000.

1/ Flow of Funds individual sector defined as households, farm business and nonfarm noncorporate business.

Moreover, a transaction tax strikes regressively at the savings and investments of Americans of modest means. About $2.1 trillion, or 24%, of the financial assets of individuals are tied up in time and savings deposits and some $228.4 billion are invested in money market funds. So too, millions of Americans have retirement funds invested in securities -- company pension plans, 401(k)s, IRAs. All these savers would bear the tax -- directly or indirectly.

Many institutions, previously tax-exempt, would pay this tax on their securities transactions. Pension fund reserves of households total almost $2.0 trillion. The vast majority of these pension monies are invested in securities. For example, insurance companies managed some $827.9 billion of private pension funds at year-end 1986. Of this amount, 96% was invested in corporate equities and credit market instruments. Moreover, state and local governments hold $501.8 billion in retirement funds, with $180.3 billion invested in equities, $158 billion in mutual funds, and $135 billion in corporate bonds.

Costs

A tax of less than 1.0% on anything appears small on superficial examination. However, it erodes the returns to all savers and investors and translates to a substantial cost increment. For example, using a 0.5% rate and an average share price on the NYSE of about $41.90 at the end of May, a pension fund manager would be paying a tax of about 21¢ per share. Estimating that institutional commissions range from 5¢ to 7¢ per share, the transactions tax increases the cost of trading by 3 to 4 times. An increase of this magnitude will artificially dampen institutional trading and subsequently reduce the estimated revenue to be generated by this tax.

For individual investors, who hold $1.9 trillion or about 63% of the total $3.0 trillion of equities outstanding, the cost of equity investment jumps with the imposition of the transaction tax. Assuming that the retail commission charge varies from 25¢ to 30¢ per share, the 20¢ transaction tax pushes costs up by 67% to 80%. On top of the 40% increase in long-term capital gains tax rates in 1987 and another 18% increase in 1988 for some investors, the average investor will think twice about equity investment.

In addition, the tax would appear to be levied twice on pass-through entities and their investors. For mutual funds, fund managers would be taxed at the fund level when they purchase and sell stocks, and the mutual fund investor might also be taxed when he purchases or sells shares of the mutual fund.

A Tax on the Winner and Loser

A tax which falls on the buyer and seller also falls on the winner and loser. It is clearly unfair to add injury to insult in the case of a capital loss. This is not a problem that can be remedied by the securities industry. While many of the operations of the industry are automated, there is no way of recording when a customer has a capital gain or loss.[8/]

8/ It was proposed several years ago that the industry report capital gain or loss information on the IRS 1099 form. However, when government realized that the industry did not track such information for most customers, gross proceeds reporting was the accepted solution.

Creating a Bias

The mountains of debt chalked up by consumers, corporations, and the government, reflect the tax code's bias favoring debt over equity. The U.S.'s low savings rate and level of capital formation have been pointed to as reasons for the erosion of U.S. competitiveness in international markets. A tax that applies only to securities investment is discriminatory. By lowering the return on securities, other assets such as real estate, art, and precious metals become that much more attractive, weighing the scales against capital formation. This bias could be eliminated by applying the tax to all assets and savings vehicles. However, neutrality would be achieved at the expense of millions more low and middle-income taxpayers who have interest-bearing passbook savings and checking accounts.

Artificial Considerations

Just as a securities transaction tax would skew the investment decision process, so too would imposing the tax on investments held for an arbitrarily determined period. By distorting economic behavior, both factors represent restraints on the free flow of capital. Market efficiency is based on the free movement and allocation of capital -- taxes and holding periods are detriments to market efficiency, keeping capital from flowing to those sectors where it is needed most and can obtain the highest return.

A Revenue-Raising Alternative

While historical experience and economic justification argue against the imposition of a transaction tax, there is a proven revenue-raiser with an outstanding track record.

TABLE II

Revenues and Realizations
($ Billions)

	SOI Series	Treasury Series		
	Sales of Capital Assets (net gain less loss)	Total Gains	Taxes Paid on Capital Gain Income	Effective Tax Rates
1977	$20.8	$ 45.3	$ 8.1	17.88%
1978	23.2	50.5	9.3	18.50
1979	28.4	73.4	11.7	15.89
1980	29.7	74.6	12.5	16.71
1981	30.8	80.9	12.7	15.61
1982	34.4	90.2	12.9	14.31
1983	48.9	122.0	18.8	15.41
1984	54.5	140.5	21.6[1]	15.41[1]
1985	66.7	NA	NA	NA

Source: Statistics of Income Bulletin and Office of the Secretary of the Treasury, Office of Tax Analysis.

1 American Council on Capital Formation estimate.

Lower capital gains tax rates have proved effective and efficient at stimulating savings and investment -- and raising government revenues.

Capital gains tax revenues collected in 1979 and 1980 exceeded Treasury projections for those years before passage of the 1978 Revenue Act. Moreover, taxes paid on capital gains income continued to increase as the lower marginal rates of the Economic Recovery Act of 1981 were phased in. In 1983, a new plateau was reached, with taxes paid on gains spurting 46% to $18.8 billion from $12.9. Based on actual gains of $140.5 billion in 1984, the American Council of Capital Formation estimates a 1984 tax take of $21.6 billion, a 15% jump from the 1983 level. No public data for later years are available at this time.

No one factor accounts for the decision to realize gains in any given year. Market data and Treasury's estimated revenue take confirm that realizations were up considerably in the latter half of 1986, as individuals reacted to the sharp capital gains increase for 1987 contained in the Tax Reform Act. However, market data for 1987 also show that a heightened pace of individual gain-taking has continued this year, as upper-bracket taxpayers retain a differential for capital gains. We believe that the strong stock market has, thus far, offset tax considerations for investors. When the market subsides, our professional experience indicates that high capital gains tax rates will reduce the willingness of investors to realize gains and on Treasury revenues.

The historical experience of the revenue-raising potential of lower capital gains rates is being continually reinforced by academic research. A recent paper by Lawrence B. Lindsey shows that the Tax Reform Act of 1986 is extremely unlikely to produce any additional capital gains taxes and more likely to produce less capital gain revenue than under the old law.9/ Lindsey's research points to a revenue maximizing capital gains rate range of between 9% to 21%.

Imposition of a Low-Rate of Withholding Tax on Interest Paid to Foreigners

The SIA strongly opposes the imposition of a low-rate of withholding on interest paid to foreigners because it would not raise meaningful revenues but would instead act as a protective tariff, preventing foreigners from buying U.S. Government and corporate interest-bearing securities and thereby leading to higher U.S. interest rates. Any incremental tax revenues generated by the withholding tax would be far outweighed by tax revenues lost as a result of increased interest deductions by U.S. private-sector borrowers and by increased costs of U.S. Treasury borrowing.

Less than three years ago in 1984, Congress eliminated the 30% withholding tax on portfolio interest in order to remove a barrier to foreign investment in U.S. debt securities.

Repeal of the withholding tax has been successful beyond all expectations:

- Net purchases by foreigners of U.S. corporate bonds increased from $903 million in 1983 to $43.5 billion in 1986;

- Net foreign purchases of Treasury Notes and Bonds rose from $3.7 billion in 1983 to $24.3 billion in 1986.

9/ Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions, Lawrence B. Lindsey, April 1987.

This very substantial inflow of funds has been an important factor in the post-1983 decline of U.S. interest rates and has helped to finance U.S. trade and budget deficits.

Reimposition of a withholding tax, even at a 5% rate, would severely curtail this trend, because it would represent a significant reduction (about 0.5%, at current interest rates) in the return to foreigners on U.S. debt securities. Foreigners would simply no longer buy significant amounts of securities subject to the withholding tax and would shift their funds to the vast supply of high-quality dollar-denominated securities issued by foreign companies and governments.

Since there would be very limited foreign investment in new U.S. debt securities (as in the period before 1984), only a negligible tax would be paid, and there would be no meaningful additional revenues to the Treasury from this source. Such a sudden shift in U.S. policy is also likely to engender skepticism on the part of foreign investors regarding the consistency of our policy toward investment by foreigners and is likely to create greater wariness than already exists about U.S. dollar denominated issues.

Before the 1984 repeal, U.S. corporations could avoid withholding tax by issuing securities through foreign finance subsidiaries, generally located in the Netherlands Antilles. This would no longer be possible under the proposed withholding tax reinstatement as a result of the recent termination of the tax treaty with the Netherlands Antilles. Thus, U.S. corporations will be forced to absorb the tax if they wish access to foreign debt markets. This incremental expense would place them at a disadvantage compared to borrowers of all other industrialized countries, each of which permits its national borrowers to issue debt securities free of withholding tax. Similarly, the U.S. Treasury will have to pay a higher interest rate to reflect the tax on its securities in order to entice foreign investors. At best, the effect will be no net revenue increase to the Government. At worst, by raising U.S. interest rates generally, the withholding tax would magnify interest payments by the Treasury and increase the budget deficit.

Finally, reimposition of a withholding tax would directly contradict the consistent recent policy of the United States in favor of deregulation of international financial markets and would undermine U.S. efforts to encourage other industrial countries (particularly Japan) in the direction of further deregulation.

The Dividends Received Deduction

The SIA urges Congress not to adopt any proposal which eliminates or sharply reduces the corporate dividends received deduction. Such action would strengthen a regime of triple taxation. Dividends would be taxed twice at the corporate level and once at the individual level, reversing the long-standing policy of taxing corporate income only once at the corporate level. This is particularly inappropriate where the distributor is the corporate alter ego of the distributee.

Significant changes in the dividends received deduction will cause serious dislocation and disruption in the securities markets. The market value of securities held predominantly by corporations (e.g., adjustable rate preferred stocks and high yield common and preferred stocks) will decline causing significant loss to shareholders.

In addition, such a rule will impair the capital markets and restrict the ability of corporations to raise capital. Dividend rates on those securities most likely to be held by corporations and the cost of raising capital will increase. Corporations will become more highly leveraged (and therefore,

more at risk) as the availability of the interest deduction increasingly causes corporations to borrow money rather than raising equity.

Market Discount Bond Proposal

The revenue options pamphlet proposed that, in an effort to increase accurate accrual of the market discount on bonds, brokers regularly report the amounts of such accruals to the IRS. This scheme is completely unworkable. There is presently no computer system which could track such accrual as the bonds pass from one investor to the next. More importantly, calculation of the accrual requires specific knowledge of the price the investor paid for the bond (and, therefore, the amount of the discount). A broker, unless he or she actually sold the bond to the investor, has no way of verifying such information. The amount of the discount, for reporting purposes, will depend solely on the word of the investor. Since this is the current scheme, a reporting requirement will effect no meaningful change in the tax system, but will substantially increase brokerage houses' administrative costs.

Other Items

The pamphlet released less than two weeks ago, "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means", includes numerous other proposals which will affect savings and investment. SIA continues to review these proposals, and regrets that it simply was not possible to formulate a response to all of them in such a short time. We will be pleased to work with this committee, and its members and staff as your consideration of revenue options continues.

SUMMARY

A securities transactions tax would be an ill-conceived one. In an era of intensifying competition for dominance in international markets, such a tax holds the potential to drive foreign investors as well as domestic ones, to other shores. In an era of recognition of the need to save and invest, such a tax strikes at the savings and investments of almost all Americans in one form or another.

SIA opposes further reduction of the dividend received deduction which mitigates triple taxation of corporate income and believes the proposal on market discount of bonds is incapable of implementation. We do remind the panel of the evidence that lowering capital gains taxes increases tax receipts.

Mr. GIBBONS. Thank you, sir. Here again we wish to commend you for being able to concentrate your statement as you did.

The American Council for Capital Formation, Mr. Bloomfield.

STATEMENT OF MARK A. BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. BLOOMFIELD. Mr. Chairman, members of this distinguished committee, my name is Mark Bloomfield. I am president of the American Council for Capital Formation.

I very much appreciate the opportunity to present new evidence in support of a 15-percent capital gains tax rate which has been suggested by several members of this committee as a revenue-raising option. It raises substantial tax revenue and does so fairly, primarily from upper income individuals.

The proposal could raise additional revenues of up to $8 billion in fiscal year 1988, $11 billion in fiscal year 1989, and $12 billion in fiscal year 1990, according to simulations of Dr. Martin Feldstein's capital gains model by his colleague at Harvard, Prof. Lawrence Lindsey. In addition, of the total $31 billion in new revenue over 3 years that this proposal could generate, nearly 80 percent of the tax receipts would come from taxpayers with incomes greater than $100,000.

Mr. Chairman, economists of all persuasions—Keynesians, conservatives, supply-siders, and liberals—all agree on the unique nature of capital gains taxes. Since capital gains taxes are voluntary, higher capital gains tax receipts do not necessarily result in greater revenues to the Government because taxpayers may choose not to realize their gains if the tax penalty is too high.

The question for policymakers thus is: What is the revenue-maximizing capital gains tax rate? The historical evidence of the 1978 and 1981 capital gains tax cuts demonstrates it is not the top rate of 50 percent. Academic studies conclude it is not the capital gains tax rates of the 1986 act. The new academic research to which I alluded suggests that the proposed 15 percent capital gains tax rate approximates the revenue-maximizing capital gains tax rate.

What happened to Government revenues after the 1978 and 1981 capital gains tax cuts? Although as a result of the 1978 and 1981 legislation, the maximum capital gains tax declined from 50 percent in 1978 to 20 percent until this year, revenues to the Treasury were 184 percent higher in 1985, the most recent available data, than they were in 1978. Inflation and economic growth cannot by themselves provide sufficient evidence for this dramatic increase in Federal revenues, coinciding with such a dramatic decrease in capital gains tax rates.

I should also add that this was not a temporary one-time unlocking because as I indicated earlier revenues increased the first year after the tax cut, but also by 184 percent over 5 years.

On the other hand, the capital gains provisions of the 1986 act result in substantial revenue losses, especially in the fiscal year 1988-90 period upon which you are now focusing, according to the Treasury Department and new academic research. It has come to my attention that the Treasury Department will shortly submit a letter to the committee clarifying Treasury's testimony yesterday,

on the revenue impact of the proposed 15 percent capital gains tax rate.

An update of a February Treasury Department revenue estimate by the American Council for Capital Formation, based on the new April tax receipts, suggests revenue losses of as much as $6 billion over the fiscal year 1988–90 period, that is of immediate concern to this committee. I should point out that this is a very, very conservative estimate.

New and startling findings by Harvard Prof. Lawrence Lindsey, based on five leading academic and Government capital gains studies are particularly relevant. Three points should be highlighted.

First, all but one of these studies predict revenue losses in the range of $27 to $105 billion under the 1986 act over a 5-year period. Dr. Martin Feldstein's model forecasts the largest or $105 billion revenue loss over 5 years.

In the period you are looking at, the 3 years of reconciliation, all but one of the same studies predict revenue losses except in the range of $17 to $65 billion with Dr. Feldstein's model predicting a revenue loss of $65 billion.

Third, all but one of the studies of the sensitivity of capital gains realizations to tax rates imply revenue-maximizing capital gains tax rates ranging from 9 percent—Dr. Feldstein's model—to 21 percent.

In conclusion, the proposed 15-percent capital gains tax rate should be a front-runner among the revenue options before this committee for three reasons: First, it is a powerful revenue raiser; second, it extracts tax revenue from upper income taxpayers; and, third, yet unlike almost all the revenue options before you, it is good for the economy.

[The statement of Mr. Bloomfield follows:]

Statement of Mark A. Bloomfield, Esq.
President, American Council for Capital Formation
before the
Committee on Ways and Means
of the
U.S. House of Representatives

Wednesday, July 8, 1987

My name is Mark A. Bloomfield. I am president of the American Council for Capital Formation. I appreciate this opportunity to present testimony in support of a 15 percent capital gains tax rate, a proposal which has been suggested by several members of this committee. While I am prepared to make the capital formation case for this proposal, the thrust of my testimony will be the revenue-raising potential and the fairness of the 15 percent capital gains tax rate, which I trust are the main concerns of this committee as it weighs the pros and cons of various options to include in a balanced deficit reduction package.

This proposal meets two critical tests. First, it raises substantial tax revenue. Second,, it raises much of that revenue fairly, primarily from upper income individuals rather than from those least able to bear an additional tax burden. The proposal could raise additional revenues of $8 billion in FY88, $11 billion in FY89, and $12 billion in FY90 according to simulations of Dr. Martin Feldstein's capital gains model by Professor Lawrence Lindsey of Harvard University. Of the total $31 billion in new revenue over three years, nearly 80 percent would be raised from taxpayers with incomes greater than $100,000.

Before I comment on this "15 percent option," I wish to commend Chairman Rostenkowski and this committee for moving promptly to comply with the reconciliation instructions in H. Con. Res. 93, the Concurrent Resolution on the Budget for Fiscal Year 1988. I share the views of most in this room that the federal deficit is the most serious economic problem facing this country today and applaud this committee's intention to act forthrightly on a balanced deficit reduction package.

The American Council for Capital Formation is a nonpartisan, nonprofit organization comprised of individuals, corporations, and associations united in their support of government policies to promote a strong economy. For more than a decade, we have focused much of our attention on the impact of tax policy on saving and investment. In particular, we have been involved in the debates of 1978, 1981, and 1986 about the appropriate taxation of capital gains. In recent months, we have devoted considerable time and resources to studying the revenue implications of the capital gains tax provisions of the Tax Reform Act of 1986. Today, I would like to share the results of this research work with you.

THE NATURE OF THE CAPITAL GAINS TAX

The capital gains tax is a voluntary tax. Taxpayers alone can decide when to realize their capital gains. Capital gains tax rates do matter significantly to investors; in addition, they impact on government revenues.

Consider the example of two taxpayers, each of whom has just realized a $100 capital gain under the pre-1986 maximum federal capital gains tax rate of 20 percent. Uncle Sam collects $40 in this example, $20 from each taxpayer. Now, consider the same taxpayers, A & B, who face the new, higher maximum federal 33 percent capital gains tax rate under the '86 act. Taxpayer B may be reluctant to realize his gain because the government will take too large a share. As a result, his gain is "locked in." The federal government is deprived of revenue. And, thus, under the '86 act, Uncle Sam collects only $33 from both taxpayers

compared to $40 under the pre-1986 lower capital gains tax rates. In fact, if one looks at combined federal and state capital gains taxes, and evaluates the difference between the old and new rules, the potential "lock-in" effect is even more dramatic. For a middle income Arkansan, the combined capital gains tax increases by 84 percent; for a similarly situated Oregonian and Virginian by 118 percent; and for a middle income New Yorker by 149 percent, according to Arthur Andersen & Co. (See Appendix A.)

The point is simple and intuitive. Economists of all persuasions--Keynesians, conservatives, supply-siders, and liberals--agree. Since capital gains taxes are voluntary, higher capital gains tax rates do not necessarily result in greater revenues to the government because taxpayers may choose not to realize their gains if the tax penalty is too high.

The question policymakers should ask is: what is the revenue-maximizing capital gains tax rate? Certainly, as the historical experience with the '78 and '81 capital gains tax changes demonstrates, it is not a top rate of 50 percent. The overwhelming weight of academic research now concludes that it is not the capital gains tax rates of the '86 act. New academic research suggests that the proposed 15 percent capital gains tax rate approximates the revenue-maximizing capital gains tax rate.

RECENT HISTORICAL EVIDENCE

The revenue impact of a lower capital gains tax is not a new issue to this committee. When the Ways and Means Committee in 1978 debated the dramatic capital gains tax cut proposed initially by Congressmen Bill Frenzel and Ed Jenkins, former Representative Ken Holland and the late Congressman Bill Steiger, proponents claimed it to be a "revenue gainer," opponents argued it to be a "revenue loser," others believed it to be a "revenue wash." The then secretary of the Treasury asserted that "the measure would cost the Treasury more than $2 billion annually."

In an attempt to clarify the revenue debate over higher and lower capital gains taxes, Congress mandated in the Revenue Act of 1978 that the Treasury Department prepare a report on the impact of capital gains tax reduction of 1978. Specifically, Treasury was asked to report to the Congress on the effect of capital gains tax changes on income tax revenue.

Of course, subsequent to the 1978 act, which reduced the maximum individual federal capital gains tax from almost 50 percent to 28 percent, the 1981 act cut the tax further to a top capital gains tax rate of 20 percent, which remained in effect through 1986.

What does the historical experience of the '78 and '81 capital gains tax cuts tell us?

First, let's look at actual Treasury capital gains tax receipts for the period 1978-1985. Although the maximum capital gains tax declined from 50 percent in 1978 to 20 percent until this year, revenues to the Treasury were 184 percent higher in 1985 (latest available data) than in 1978. Inflation and GNP growth cannot by themselves provide sufficient explanation for this dramatic increase in federal revenues coinciding with a dramatic decrease in capital gains tax rates.

Second, let's look at the extremely cautious summary of the Treasury Department's capital gains report, Capital Gains Tax Reductions of 1978 (September 1985). It concluded that: "the reduction in tax rates on capital gains in the 1978 act caused a substantial increase in revenue from capital gains taxes in the first year after the tax cut."

What the recent historical experience with the '78 and '81 capital gains tax cuts proves makes common sense. Within some reasonable range, lower capital gains taxes increase the flow to government coffers (the '78 and '81 acts) and, conversely, higher capital gains taxes can decrease government revenues (the *'86 act*).

CAPITAL GAINS PROVISIONS OF THE '86 ACT

In brief, the Tax Reform Act of 1986 increases the individual federal capital gains tax rate from a maximum of 20 percent to 28 percent (or 33 percent for joint returns between $71,900 and $149,250 and up to 49 percent for some investors). It is the largest capital gains tax rate increase since 1934.

What is relevant for the hearings today is the impact of these capital gains changes on government revenues, especially since this committee has been instructed to raise $64.3 billion over the next three fiscal years ($19.3 billion in FY88, $22.0 billion in FY89, and $23.0 billion in FY90).

Let's look at the official government revenue estimates of the capital gains provisions of the '86 act.

To the best of my knowledge, Joint Committee on Taxation revenue estimates are unavailable. The "Blue Book" or General Explanation of the Tax Reform Act of 1986, does not identify a separate revenue impact for the capital gain and loss provisions. A footnote explains that this effect is included in the rate reduction budget estimates. According to a Treasury Department estimate of February 1987, the short-term revenue impact of the '86 capital gains tax changes is $12.5 billion in additional revenue in FY87. That is now history. The Treasury also predicts revenue losses in the critical next two fiscal years, in the amount of -$1.5 billion in FY88 and -$0.1 billion in FY89. (See Appendix B, column 1.)

Part of what the Treasury predicted makes sense. Many investors accelerated their profit taking at the end of calendar year 1986 (FY87) to take advantage of the much lower capital gains tax rates under the old law. Having accelerated these gains, taxpayers obviously will realize fewer gains for the next three to four years. More importantly, the higher capital gains tax rates under the '86 act will extend investors' holding periods on their remaining portfolios and encourage them not to realize gains at all. This effectively creates a massive "lock in" that will rob the federal government of revenue.

The February Treasury Department capital gains revenue estimate of the '86 act was done before the unparalleled surge in April Treasury receipts, to a large extent dominated by taxes on capital gains realized last year.

If one extrapolates from this new raw data, especially the April federal receipts and similar increases in state tax receipts from 1986 activities, to update the Treasury's earlier estimates, the impact of the '86 act is even more dramatic. Our analysis, at the American Council for Capital Formation, is that the new data suggests that the Treasury numbers should be revised to show $15-25 billion in increased revenues in FY87, as compared to the original $12.5 billion estimate. This also translates into a revenue loss of as much as -$6 billion over the FY88-90 period.

Let's now look at some new and startling academic findings on the revenue implications of the 1986 capital gains tax changes. Earlier this year, Harvard Professor Lawrence Lindsey simulated the revenue impact of the '86 act capital gains changes for FY87-91 based on the findings of five of the recent leading academic and government investigations of capital gains taxation. The studies all examined the responsiveness of

taxpayers to changes in capital gains tax rates. Dr. Lindsey simulated the revenue impact of the new capital gains tax rules using a total of 13 sets of behavorial parameters identified in the studies. (See Appendix C.)

Three of Dr. Lindsey's findings are particularly relevant as this committee acts to meet the mandated revenue targets of $64.3 billion for FY88-90 under budget reconciliation.

First, all but one of these studies predict revenue losses in the range of -$27 billion to -$105 billion under the '86 act compared to prior law over the FY87-91 period, with Dr. Feldstein's model forecasting the -$105 billion revenue decline. The average of the academic and government studies shows a revenue loss of -$38.7 billion over the FY87-91 period, according to Dr. Lindsey. A similar study by Peat Marwick projects revenue losses averaging -$34.2 over the five year period. (See Appendices B and C.)

Second, the same studies predict revenue losses in the range of -$17 billion to -$65 billion under the '86 act compared to prior law over the next three years (FY88-FY90), again with Dr. Feldstein's model suggesting the largest or -$65 billion revenue decline. The average of the academic and government studies predicts a revenue loss of -$31.7 billion over the FY88-90 period. Peat Marwick's study projects revenue losses of -$37.4 billion over the three year budget period. (See Appendices B and C.)

Third, according to Professor Lindsey's analysis, all but one of the academic and government investigations of the sensitivity of capital gains realizations to tax rates imply revenue maximizing capital gains tax rates ranging from 9 percent to 21 percent.

In conclusion, the preponderance of the evidence suggests that one, the '86 act capital gains provisions will result in revenue losses for the next several fiscal years; two, the long run level of capital gains tax revenues will be lower under the '86 act than the old law; and three, a carefully constructed 15 percent capital gains tax rate, effective date of enactment or 1/1/88, whichever is earlier, could provide a needed revenue bonus for FY88-90 and beyond.

THE 15 PERCENT SOLUTION

I urge this committee to consider the proposed 15 percent capital gains tax as a departure point for the crafting of a capital gains tax reduction as an innovative element of the $64.3 billion revenue-raising package for FY88-90, with which you are charged.

The 15 percent rate is suggested only because it falls in the middle of the range of the 9 percent to 21 percent revenue-maximizing capital gains tax rate in the Lindsey study. An obvious alternative approach would be to enact a 40 percent exclusion for capital gains which, applied to the '86 act marginal tax rate brackets, results in a range of capital gains tax rates from 9 percent to 19.8 percent.

Based on the findings of the five recent leading academic and government investigations of capital gains taxation, Professor Lindsey estimates a new 15 percent capital gains tax rate increases capital gains revenues an average of $4 billion in FY88, $5 billion in FY89, and almost $6 billion in FY90. Professor Lindsey's simulation of the 15 percent proposal with Dr. Feldstein's methodology yields revenue gains of almost $8 billion in FY88, $11 billion in FY89, and $12 billion in FY90. (See Appendix B).

A significant capital gains tax cut effective, for example, July 1, 1987, perhaps to a maximum 15 percent could be a bold element of a balanced deficit reduction package. Such action would also not require any significant reopening of the tax code since Congress, in 1986, wisely left the capital gains structure in the internal revenue code.

THE FAIRNESS ISSUE

All the historical data plus the recent academic research done by Professor Lindsey indicate that lower capital gains tax rates coincide with higher government revenues from upper income taxpayers.

In the period 1978-85, when capital gains taxes were reduced from 50 percent to 20 percent, total individual capital gains tax receipts increased from $9.1 billion to $25.9 billion. The bulk of this new revenue for Uncle Sam came from upper income taxpayers. Total capital gains realized by those with annual incomes over $100,000 increased over one thousand percent between 1978 and 1984 (latest data available) compared to a 195 percent increase for those with incomes below $100,000.

Dr. Lindsey's research shows that most of the revenue increase comes from high income taxpayers. As mentioned earlier, Dr. Lindsey projects average revenue gains of $4 billion (FY88), $5 billion (FY89), and almost $6 billion (FY90) for a total of $15 billion over the FY88-90 period under the 15 percent proposal. Taxpayers with incomes of $100,000 and above account for over 70 percent of the revenue increase. Those with incomes of $200,000 and above account for nearly 40 percent of the revenue gain.

Simulations of Dr. Feldstein's model of the 15 percent proposal show a similar pattern of revenue gain: 8 billion (FY88), $11 billion (FY89), and $12 billion (FY90) for a total of $31 billion over the three year period. Taxpayers with incomes of $100,000 and above account for almost 80 percent of the revenue increase. Those with incomes of $200,000 and above account for more than 50 percent.

It is important to realize that the tax yield on unrealized, locked in capital gains is precisely zero. It is wrong to describe a capital gains tax rate reduction as a "tax break for the wealthy" when in fact the taxes paid by this sector will multiply dramatically.

CONCLUSION

Although I have focused my testimony appropriately on the revenue implications of a low capital gains tax rate, there is, of course, a strong capital formation case to be made for a significant capital gains tax differential.

The 1978 and 1981 capital gains tax cuts proved to be an economic success story. These cuts improved the investment climate, facilitated a record number of new stock offerings, and bolstered corporate equity values and employment gains across the entire spectrum of the economy. Our international competitors recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation. A new Arthur Andersen & Co. study comparing tax rates on portfolio stock investment among eleven major industrialized countries and six Pacific Basin countries, reveals that, in 1987, U.S. capital gains taxes are higher than almost all surveyed countries. Japan, Germany, and South Korea, among others, exempt from taxation all long-term capital gains from portfolio stock investments.

I also would be remiss if I did not note other capital gains impacting items in the pamphlet prepared for this hearing. For instance, neither the 1987 rate freeze proposal nor the items

setting the top marginal rate at 33 percent contain a capital gains rate differential. An alternative staff option to set the top rate at 38.5 percent does leave the capital gains rate at the present 28 percent statutory level. While we, along with many others, consider marginal tax rate increases a breach of faith with last year's tax reform compact, we do urge that, if you undertake such an initiative, it is incumbent upon you to restore a meaningful capital gains differential at a 20 percent or lower rate.

In closing, the proposed 15 percent capital gains tax rate, suggested by several members of this committee, should be a front-runner among your revenue options. It is a powerful revenue-raiser. It extracts tax revenue from upper income taxpayers, rather than the low and middle income taxpayers. Yet, unlike almost all the revenue options before you, it is good for the economy.

Appendix A: Comparisons of Combined Federal and State Capital Gains Tax Rates Under Prior Law and Under the Tax Reform Act of 1986

State	Combined Federal and Marginal State Capital Gains Tax Rate		
	1985	1988	% Change
Alabama	15.5	30.6	97.4
Arizona	14.6	31.9	118.5
Arkansas	17.9	33.0	84.4
California	20.6	35.9	74.3
Colorado	14.7	32.3	119.7
Connecticut	15.1	33.0	118.5
Delaware	15.9	35.7	124.5
Dist. of Columbia	16.2	35.9	121.6
Georgia	17.2	32.3	87.8
Hawaii	15.6	34.6	121.8
Idaho	15.2	33.4	119.7
Illinois	14.9	29.8	100.0
Indiana	14.0	30.2	115.7
Iowa	15.3	34.0	122.2
Kansas	14.6	32.0	119.2
Kentucky	16.0	31.2	95.0
Louisiana	13.9	30.0	115.8
Maine	15.7	34.6	120.4
Maryland	15.2	33.4	119.7
Massachusetts	20.4	35.8	75.5
Michigan	12.7	31.8	150.4
Minnesota	15.9	35.1	120.8
Mississippi	16.4	31.4	91.5
Missouri	14.3	31.2	118.2
Montana	15.1	33.4	121.2
Nebraska	14.9	31.8	113.4
New Jersey	15.6	30.5	95.5
New Mexico	14.6	31.8	117.8
New York	15.2	37.9	149.3
North Carolina	17.9	33.0	84.4
North Dakota	14.1	30.1	113.5
Ohio	14.9	32.6	118.8
Oklahoma	14.7	32.1	118.4
Oregon	15.3	33.4	118.3
Pennsylvania	14.8	29.7	100.7
Rhode Island	15.1	32.4	114.6
South Carolina	15.0	32.7	118.0
Utah	14.6	32.1	119.9
Vermont	15.4	33.0	114.3
Virginia	14.7	32.1	118.4
West Virginia	15.2	34.6	127.6
Wisconsin	13.9	34.8	150.4

Note: The example assumes that the taxpayer has salary income of $50,000 and that he realizes a $10,000 long term gain. The marginal state capital tax rate is adjusted to reflect the Federal tax savings due to the deduction for state income tax.

Source: Data Developed by Arthur Andersen & Company for Fortune Magazine.

Appendix B : Capital Gains Revenue Estimates
($ in billions)

	CAPITAL GAINS PROVISIONS OF THE TAX REFORM ACT OF 1986			PROPOSED 15% RATE	
Fiscal Year	(1) Treasury	(2) Lindsey Average	(3) Peat Marwick Average	(4) Feldstein	(5) Lindsey Average
1987	$12.5	$ 6.0	9.2		
1988	(1.5)	(9.1)	(16.4)	$ 7.7	$ 3.8
1989	(0.1)	(10.7)	(14.2)	11.0	5.3
1990	3.4	(11.9)	(6.8)	11.8	5.7
1991	7.4	(13.0)	(6.0)	12.7	6.0
1988-90	$ 1.8	($31.7)	($37.4)	$30.5	$14.8
1987-91	$21.8	($38.7)	($34.2)		

1/ Column 1 is the Treasury Department's estimate (February, 1987) of the revenue impact of the capital gains provisions of Tax Reform Act of 1986. Totals may not add due to rounding.

2/ Column 2 is the average revenue impact of the capital gains provisions of the Tax Reform Act of 1986 as calculated by Harvard professor and National of Bureau of Economic Research fellow Dr. Lawrence Lindsey. Professor Lindsey's calculation draws upon the studies by Treasury (cross section-1985); Lindsey (1987); and Auten and Clotfelter (1982) and the assumption that taxpayers acted on the knowledge of capital gains tax increases effective 1/1/87.

3/ Column 3 is the average revenue impact of the capital gains provisions of the Tax Reform Act of 1986 as calculated by the Policy Economics Group of Peat Marwick. The Peat Marwick calculations are based on six analyses. These are: Treasury (cross section-1985); Feldstein, Slemrod and Yitzhaki (1980); Minarik (1981); Lindsey (1987); Congressional Budget Office (time series-1986); and Treasury (time series-1985). The Peat Marwick analysis was prepared for the American Council for Capital Formation Center for Policy Research in June, 1987.

4/ Column 4 is Professor Lawrence Lindsey's estimate of the revenue impact of the proposed 15 percent capital gains tax rate (effective 1/1/88) based on the methodology used in the Feldstein study (1980).

5/ Column 5 is Professor Lindsey's calculation of the average revenue impact of the 15% capital gains tax proposal based on several prominent studies. These are: Treasury (cross section-1985); Lindsey (1987); Auten and Clotfelter (1982); Feldstein, Slemrod, and Yitzhaki (1980); and Minarik (1981).

APPENDIX C

American Council for Capital Formation
Center for Policy Research

April 1987

SPECIAL REPORT

Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions

by Lawrence B. Lindsey*

During the congressional consideration of the Tax Reform Act of 1986 (TRA) there was much controversy about the revenue impact of the elimination of the capital gains tax differential. Proponents of the repeal claimed significant tax revenue increases would result. Others, pointing to historical data and analytical work, said the increase in capital gains tax rates would be a revenue loser. To further a constructive debate on TRA's impact on capital gains tax revenues the ACCF Center for Policy Research is pleased to summarize below the findings of a recent paper, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," by Dr. Lawrence B. Lindsey. The paper contains simulations of the effect of TRA for calendar years 1986-1991 and for fiscal years 1987-1991 using 13 different behavioral models. These models were derived from the academic findings of Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki; the Department of Treasury; Lawrence Lindsey; Gerald Auten and Charles Clotfelter; and Joseph Minarik. The Lindsey paper will be published as a working paper by Harvard University and by the National Bureau of Economic Research, as well as presented at the annual meeting of the National Tax Association—Tax Institute of America on May 19, in Washington, D.C.

This paper examines the likely effects of the Tax Reform Act of 1986 on capital gains realizations and tax revenue. The major conclusions of the study are:

- The Tax Reform Act of 1986 involves the largest capital gains tax rate increase, at least since 1934, and probably since the advent of the income tax in 1913.
- All but one of the academic investigations of the sensitivity of capital gains realizations to tax rates imply that revenue maximizing rates range from 9 to 21 percent.
- In spite of the apparent disparity of findings, the academic literature suggests that it is extremely unlikely that the Tax Reform Act of 1986 will produce any additional capital gains tax revenue, and will most likely produce less revenue than resulted from the much lower tax rates of the old tax law. All but one of the academic studies predict revenue losses in the range of $27 to $105 billion compared to prior law over the FY1987-1991 period. For FY1988 and 1989, the combined revenue losses range from $11 to $42 billion.

The study begins by evaluating the effect of the federal tax reform bill on marginal tax rates of long-term capital gains. It shows that taxpayers with incomes under $30,000 will generally see a tripling of their capital gains tax rates. Taxpayers with incomes between $30,000 and $200,000 will see their marginal tax rates on capital gains double. Those taxpayers earning over $200,000 will see an increase in tax rates of about 75 percent. In total, the average marginal tax rate facing capital gains recipients will rise from about 9 percent under old law to more than 21 percent under the new tax law. Weighted by the amount of capital gains received, the average federal marginal tax rate will rise from a bit under 15 percent to 27 percent. (When the impact of changes in state tax rates are included the rate increases are even greater.)

The study applies these federal tax rate changes to the findings of five of the leading academic investigations of capital gains taxation. The five studies all examined the responsiveness of taxpayers to changes in their capital gains tax rates. They relied on widely different data bases and produced a wide range of results.

The study reporting the greatest responsiveness of taxpayers was done by Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki. They used detailed tax return data on the sale of common stocks to compute the effective tax rates of a taxpayer's long term gains. This 1980 paper was published in the *Quarterly Journal of Economics*. The next greatest response of taxpayers was reported in the 1985

* Lawrence B. Lindsey is an assistant professor of economics at Harvard University and a faculty research fellow at the National Bureau of Economic Research. The expert computer assistance of Andrew Mitrusi is gratefully acknowledged. The views expressed in this paper are the author's alone and not those of any group or organization.

This special report is one of a series of papers on capital formation issues published to further public debate on economic policy. For additional copies write to ACCF Center for Policy Research, 1850 K Street, N.W., Suite 400, Washington, DC 20006, or call (202)293-5811.

Report to the Congress by the Department of Treasury on the capital gains tax changes of 1978. This document reported that the large capital gains tax reductions of that year produced more capital gains revenue than would have been received under the earlier set of higher tax rates. The third greatest amount of taxpayer responsiveness was reported in Lawrence Lindsey's 1986 paper on 18 years of capital gains taxation. This study is forthcoming in a *National Bureau of Economic Research* volume on taxes and capital formation. The next greatest degree of taxpayer sensitivity to tax rates was a 1982 piece by Gerald Auten and Charles Clotfelter published in the *Quarterly Journal of Economics* which relied on work they had undertaken while at the Department of Treasury's Office of Tax Analysis. The least amount of taxpayer responsiveness was reported in a paper by Joseph Minarik published by *The Brookings Institution*. This piece was a re-examination of the work of Feldstein, Slemrod, and Yitzhaki which used a different econometric technique and a different model of realization behavior.

It should be stressed that these authors investigated capital gains tax rate variations that were much smaller than those contemplated in the current tax reform. Furthermore, much of the variation in tax rates which these authors investigated was among upper income taxpayers. It is not certain that taxpayers in lower income brackets will respond in the same fashion as those in upper brackets. Nor is it certain that taxpayers will respond to the largest capital gains tax rate increase in history in the same proportion as the response they've demonstrated to much smaller capital gains tax changes in the past. In addition, outside the scope of this paper but relevant to investor behavior is the total federal and state tax on capital gains. Unless state corrective action is taken, the new combined federal and state capital gains tax rate will range from a low of 29.7 percent in Pennsylvania to a high of 37.9 percent in New York for taxpayers in the 28 percent federal tax bracket. Therefore, the best interpretation of the results is as a range of likely taxpayer behaviors, and particular attention should not be given to any single estimate.

In order to provide the widest possible investigation of potential taxpayer responses, a total of 13 sets of behavioral parameters are obtained from the five studies. These parameters estimate both the permanent, long-run effect of capital gains tax rates and the temporary effect of capital gains tax changes on taxpayer behavior. Taxpayers are modeled both as considering past tax rates as well as future tax rates in making their decisions.

Of the 13 sets of assumptions, 12 predict that the *permanent* level of capital gains tax revenues will be lower under the new law than under the old law. The 13th set of assumptions, based on Minarik's work, suggests that capital gains tax revenues will be virtually unchanged under the new law. The apparent revenue neutrality in the Minarik model is the result of major tax increases on lower income capital gains recipients offsetting modest tax revenue reductions by upper income recipients who will realize fewer gains than under prior law.

Of the 12 models predicting lower permanent levels of revenue, 11 predict that the revenue will also be lower in the five years of the current budget cycle: FY1987-FY1991. The only model predicting an increase in the current five year period is a variant of the work of Auten and Clotfelter. This model assumes that taxpayers are extremely sensitive to *future* increases in capital gains tax rates. As a result, this model predicts that taxpayers realized so many capital gains in late 1986 (2.5 times the normal level) that the added revenue offset the future declines in tax revenue. These results would have to be considered extreme.

The table presented below indicates the revenue maximizing level of tax rates and the percent decline in revenue in FY 1988 under the Tax Reform Act relative to prior law predicted by each of the studies investigated.

Research Findings	Revenue Maximizing Capital Gains Tax	% Change in 1988 Capital Gains Revenue
Feldstein, Slemrod & Yitzhaki	9%	−72%
Dept. of Treasury	12%	−48%
Lindsey	18%	−29%
Auten & Clotfelter	21%	−19%
Minarik	28%	+ 1%

The evidence provided in the paper is overwhelming that a marginal tax rate reduction for long term gains will increase capital gains tax revenue. The only positive revenue gains predicted in the various models resulted from accelerated realizations in late 1986 in anticipation of future tax rate increases. To the extent that these revenues enhance the total taxes collected under the tax reform act, it should be noted that these tax revenues have already been received. Therefore, prospective capital gains tax rates in the range of 9 to 21 percent can capture the benefits associated with permanently lower rates without sacrificing the temporary revenue gains of the tax rate increases enacted in the Tax Reform Act of 1986.

Mr. GIBBONS. Thank you, Mr. Bloomfield.
Mr. Minarik.

STATEMENT OF JOSEPH J. MINARIK, PH.D., SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

Mr. MINARIK. Mr. Chairman, before I say anything else, let me emphasize I am here on my own behalf, and my testimony and the opinions I express should not be assigned to any organization. I am here in particular to discuss the proposal in the revenue-raising book to reduce the maximum tax rate on capital gains to 15 percent.

My contention is that that proposal does not belong in a discussion in this context. It is not a revenue raiser. It may have merits under some other particular views of tax policy questions, but here it is misplaced.

There are two arguments often used as to why a capital gains tax rate cut could increase revenues. First of all, looking at the historical record—that is, what happened in the cases of the most recent tax rate reductions—and, second, looking at the academic literature which I will describe as predictive, looking at individual taxpayer behavior in a particular year and trying to infer how those taxpayers would behave in the future.

In my view, this case falls, really, on both counts. First of all, let us look at the historical record of the recent tax reduction. It is easy to trump up a case for a revenue-raising implication of a capital gains tax rate. You have to do two things: First, ignore the distinction between the transient response to a capital gains reduction and the continuing response to that reduction; second, ignore all nontax forces that would tend to cause capital gains to increase over time.

First of all, in the transient continuing distinction, all economists would agree that a capital gains tax reduction will increase realizations in the very short run. Anybody who hears that a tax rate reduction is coming is going to postpone realizations until the reduction arrived, and for that reason rate reduction will look as though it is producing additional revenues.

Second, anybody sitting on the fence as to whether he would realize a gain or not is going to find that if the rates are reduced, the fence is moved. Therefore, it is likely that that person is going to realize under that incentive.

However, those are totally different questions from whether or not, year in and year out, taxpayers will choose to realize more gains if tax rates on capital gains are lowered.

Now, on the second question—that is, the nontax forces that tend to increase capital gains realizations—over the past quarter of a century capital gains have increased year-to-year almost every year, with the only exceptions being years of strong recession or years when the stock market declined; and, in particular, in years when the stock market increased substantially, capital gains realizations have increased substantially as well.

So it not enough to say that capital gains taxes were cut and realizations went up, therefore, there was a direct effect of the capital gains tax reduction. That is rather like a jogger running from

west to east and taking credit for the rotation of the Earth. You need more than that to justify that kind of a policy.

Now, in my written statement, I have made a simple estimate of the effects of the 1978 and the 1981 tax cuts on a historical basis. The Treasury Department has done the same thing in its study of the effects of capital gains reductions that was released a few years ago. My results and the Treasury's results are similar.

In the first year after the 1978 tax reduction, Treasury estimates about a $1 billion revenue increase; so do I. Later on, Treasury estimates very little change; I estimate a small decrease. Both Treasury and my estimates show that the 1981 tax cut—which, incidentally, was from a 28 percent maximum rate which is where we are now—lost revenue. Both Treasury and I estimate that the 1981 tax reductions lost revenue on the basis of the historical data. So much for that one point.

Now, let us look at the academic literature. Much has been made recently of papers released by Professor Lindsey, and Mark Bloomfield, my colleague on the panel, mentioned them just a moment ago. I am in a particularly good position to evaluate Professor Lindsey's paper because my research, my paper on this subject, is one of the five that Professor Lindsey purports to represent in making estimates of the effects of capital gains reductions.

Let me just point out very quickly, I was very surprised when I looked at Professor Lindsey's paper and discovered that my results would predict no revenue change from a reduction of capital gains rates to a maximum of 15 percent, because I used my results and simulated the 1978 tax change and found a permanent revenue decrease.

I was also surprised to look and find that several of the other papers that Professor Lindsey purported to represent also, in estimating their own findings, had come up with very different results from what Professor Lindsey found.

Now, that does not make sense. How is it that Professor Lindsey can take my results and other people's results and come up with different answers in terms of revenue implications? Well, it is very simple. He changes them.

In my own particular case, I worked to attempt to estimate differences in taxpayer behavior from one taxpayer to another based on their different circumstances. What Professor Lindsey did was to pick one particular taxpayer circumstance and apply it to everybody. The results just happened to be to increase the expected taxpayer behavioral response. I do not know if that is why he did it, but that is the result.

The same thing is true if I examine several of the other papers there. The change is not necessarily always up; sometimes down, but always in a very convenient direction to attempt to buttress his case.

Now, I have to say in summary with respect to Professor Lindsey's paper, that any similarity between my own research and what he purports my research to say is entirely coincidental. I believe on my examination of the other papers involved there that the conclusion is the same. All of those pieces of research have been altered in attempting to reach his conclusion.

So let me say again that I believe the two arguments, the two possible bases for saying that capital gains tax cuts are revenue raisers both fall. The historical record does not support it; the academic research does not support it.

If you want to raise revenue in the capital gains area, there is one proven revenue raising device, and that is to tax capital gains at death. If you want to look at capital gains tax policy on other grounds, apart from raising revenue, that is certainly a reasonable thing to do, but this is not the time or the place when time is short, as is revenue.

As far as I am concerned, the reductions in capital gains tax rates are supply-side economics pure and simple. It did not work in 1978; it did not work in 1981. Let us not make the same mistake three times.

Thank you, Mr. Chairman.

[The statement of Mr. Minarik follows:]

CAPITAL GAINS TAX RATE CUTS AND REVENUE

Statement of

Joseph J. Minarik

Before the Committee on Ways and Means

U. S. House of Representatives

July 8, 1987

OPINIONS EXPRESSED HEREIN ARE THE AUTHOR'S ALONE AND SHOULD NOT BE ATTRIBUTED TO ANY ORGANIZATION.

There has been some interest of late in reducing the maximum tax rate on long-term capital gains to increase tax revenues. This counterintuitive notion is based on two premises: first, that a capital gains tax rate cut in 1978 increased revenues; and second, that the body of the academic literature predicts such an increase. It is my contention that both of these premises are false, and that cutting tax rates will not increase revenues. Let me deal with these premises in turn.

The Precedent of the 1978 and 1981 Capital Gains Tax Cuts

Claims that the 1978 capital gains tax rate cut increased revenues are based on two errors: first, a failure to distinguish between the transient and the continuing effects of a capital gains tax change; and second, a failure to recognize other causes of changes in capital gains realizations.

A cut in capital gains tax rates will increase realizations for reasons that are purely temporary. If a future cut in capital gains tax rates is announced, just about anyone who plans to realize a gain will postpone that realization until the tax cut takes effect; that will make the impact of the tax cut appear larger temporarily. Further, if an assetholder is sitting on the fence over whether to realize a gain, cutting tax rates will in effect move the fence and induce him to sell. It is a totally different question, however, whether a capital gains tax cut will induce so much more realization, year in and year out, that it will more that offset its static effect and actually increase revenue. When there is nothing to be gained by shifting a realization earlier or later, and once the figurative fence is again firmly planted in the ground, the remaining, continuing effect of a capital gains tax cut is smaller than the transient effect. Looking over only a short time span can easily exaggerate the effects of a capital gains tax change.

Likewise, tax effects can be exaggerated by ignoring other determinants of capital gains realizations. Over the long haul, through tax increases and tax decreases, capital gains realizations have tended to follow the growth of the economy, with further upward and downward swings propelled by the stock market. Ignoring these fundamental determinants of realizations can make tax changes look much more powerful than they are--rather like giving a jogger running toward the east additional credit for the rotation of the earth.

To illustrate both of these points, consider figure 1, which shows net long-term capital gain in excess of net short-term capital loss on individual income tax returns from 1960 through 1977, together with the gross national product (GNP). Note that realizations closely follow GNP in the early 1970s, then move ahead in 1964--some might say because of the passage of the tax cuts. But realizations go nowhere special in 1965, only to take a big jump with the rapid growth and booming stock market of the late 1960s. Realizations fall in 1969 and 1970--some would say

because of the capital gains tax increase, some would say because of the recession. But they pick up again as soon as the economy and the market resume growth. They fall behind again in the deep recession of 1974-75, but pick up once more as the economy and the market recover. The obvious lesson here, as far as I am concerned, is that tax changes don't move realizations--at least not very much, or for very long. On the contrary, it is the stock market that moves realizations ahead of or behind their central tendency, which is the path of the economy.

How does this lesson illuminate the experiences of 1978 and 1981? First, it is not enough to say that a tax cut in year two increased revenues over year one; we need to look at years three and four, as well. Second, it is doubly wrong to attribute an entire year-over-year increase in capital gains to the tax cut; capital gains will increase roughly in step with the economy, with or without tax changes. And third, we must consider the very strong effects of the stock market in pushing realizations up and down as well.

With those considerations in mind, look at figure 2, which shows the path of capital gains realizations since 1978, along with the predicted "baseline" path without the tax cut, keyed to the growth of the economy, and the "target" path, the level of realizations needed to make the 1978 and the 1981 capital gains tax cuts revenue neutral. (Because the 1978 tax cut was basically a 20 percent cut--increasing the exclusion from 50 percent to 60 percent--realizations would have to be 20 percent greater to hold revenues constant. By the same token, the 1981 tax cut was basically a 23 percent rate cut across the board. In each instance, the tax cut was even greater for some taxpayers--in 1978, some were relieved of the minimum and maximum tax effects, and in 1981, 70-percent-bracket taxpayers got a 29 percent rate cut. Therefore, my "target" path, which assumes the smaller 20 and 23 percent tax cuts, is generous to the hypothesis that the tax cuts made money.)

Figure 2 suggests that the 1978 tax cut just about broke even in 1979 (assuming, again, that realizations in the absence of the tax cut would have grown in step with the economy), but the subsequent history reveals that that effect was transitory. In the very next year, realizations were below the break-even level, and the 1981 tax cuts hardly budged them (partly because of the recession). Realizations did increase in 1983, but too late after the tax cut to assign it much causal effect. Rather, the boom in realizations in 1983 was likely the result of the enormous bull market that accompanied the exit from the 1981-82 recession and the conquest of inflation. Figure 3 puts that point in perspective by showing that the increase in market values in 1983 was unprecedented in the preceding quarter century. By the scale of the 1983 bull market, the increase in realizations in that year was small, as figure 3 shows. (Figure 3 also helps to demonstrate that the initial response to the 1978 tax cuts was transient. In 1980, the second year in which the tax cuts had full effect, the market had a surge virtually the equal of anything in the preceding two decades, but realizations declined. This unprecedented failure of realizations to respond to the market strongly indicates that the growth in realizations in the preceding year was larger than was likely to continue over the long haul.)

In sum, the history of the last decade is not favorable to the revenue raising potential of capital gains tax rate cuts. Absent this historical precedent, arguments for capital gains tax cuts as a deficit remedy must rest on the predictions in the empirical literature.

The Academic Literature

The only recent argument for the revenue productivity of capital gains tax cuts on the basis of the literature in the field has been made by Lawrence Lindsey. I am in a good position to

evaluate Professor Lindsey's paper, because my work is among the literature that Lindsey purports to summarize. And while I have every intention of being courteous and collegial in my comments, I must also be honest and frank.

My own work on capital gains taxation suggests that behavioral responses to tax changes are identifiable, but are much too small to reverse the static revenue impact. Confronted with this finding in his summary of the literature, Lindsey might have undertaken a critical evaluation of my methodology to justify his own position. Instead, he changed my results. Specifically, he drastically oversimplifies my computations, and then alleges that my research suggests that the establishment of a 15 percent maximum capital gains tax rate would lose virtually no revenue. (The effect of Lindsey's manipulation is to exaggerate the behavioral responses of upper-income taxpayers.) Yet the very paper that Lindsey cites contains my own detailed simulation of the 1978 capital gains tax cuts, showing that they would lose revenue. Simulated with the same detail, the new proposal and the 1978 law would have the same effect. Lindsey could have tested his interpretation of my work on the 1978 tax law change, to see if he were accurately replicating my results, yet he chose not to.

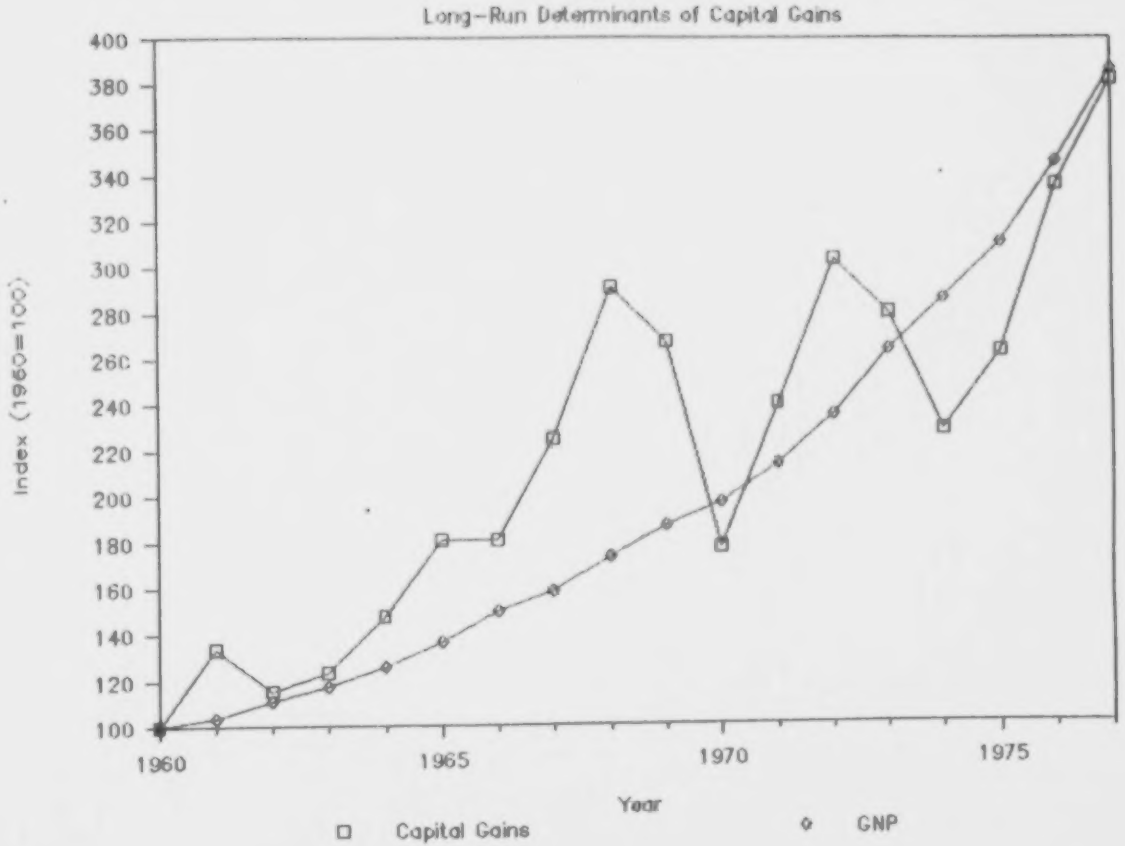
Lindsey's questionable practices do not stop with my work. He summarizes two other papers, one by Martin Feldstein and one of his own, that indicate that after the capital gains tax increase in the Tax Reform Act of 1986 there will be virtually no realization of capital gains. Confronted with these outlandish results, Lindsey could have determined that the papers were incorrect, or that they at least did not apply to tax changes of this magnitude. Instead, again, he changed the results. (The effect of Lindsey's manipulations here is to moderate what would have been enormous behavioral responses of moderate-income taxpayers.) Here again, there was an opportunity to check his interpretation; Feldstein's paper included a simulation of the 1978 tax law change, which he predicted would cause capital gains realizations to immediately triple. (Six years and another capital gains tax cut later, they have yet to do so.) Lindsey could have checked to see if his interpretation of Feldstein's work agreed with Feldstein's own results, but he chose not to. There is every indication that all of Lindsey's characterizations of papers in the literature are as inaccurate as those of my work and of Feldstein's.

In sum, I see no reason to believe Professor Lindsey's predictions of revenue increases from capital gains tax cuts; his interpretation of the literature is demonstrably faulty.

Conclusion

The proposal to cut capital gains taxes is supply-side economics--nothing more, nothing less. We have been there before. The 1978 capital gains tax cut was predicted to boost growth and productivity, and the 1981 tax cut was predicted to fill our treasury. Instead, we have had declining competitiveness, a bulging deficit; and a proliferation of tax shelters that have dashed public confidence in the fairness of our tax system. With the Tax Reform Act of 1986, we have a new tax law that rewards value in the marketplace, and taxes equally persons with equal incomes. Let us keep what we have achieved; let us not make the same mistake three times.

Figure 1


Long-Run Determinants of Capital Gains
Index (1960=100)
400
380
360
340
320
300
280
260
240
220
200
180
160
140
120
100
1960
1965
1970
1975
Year
Capital Gains
GNP

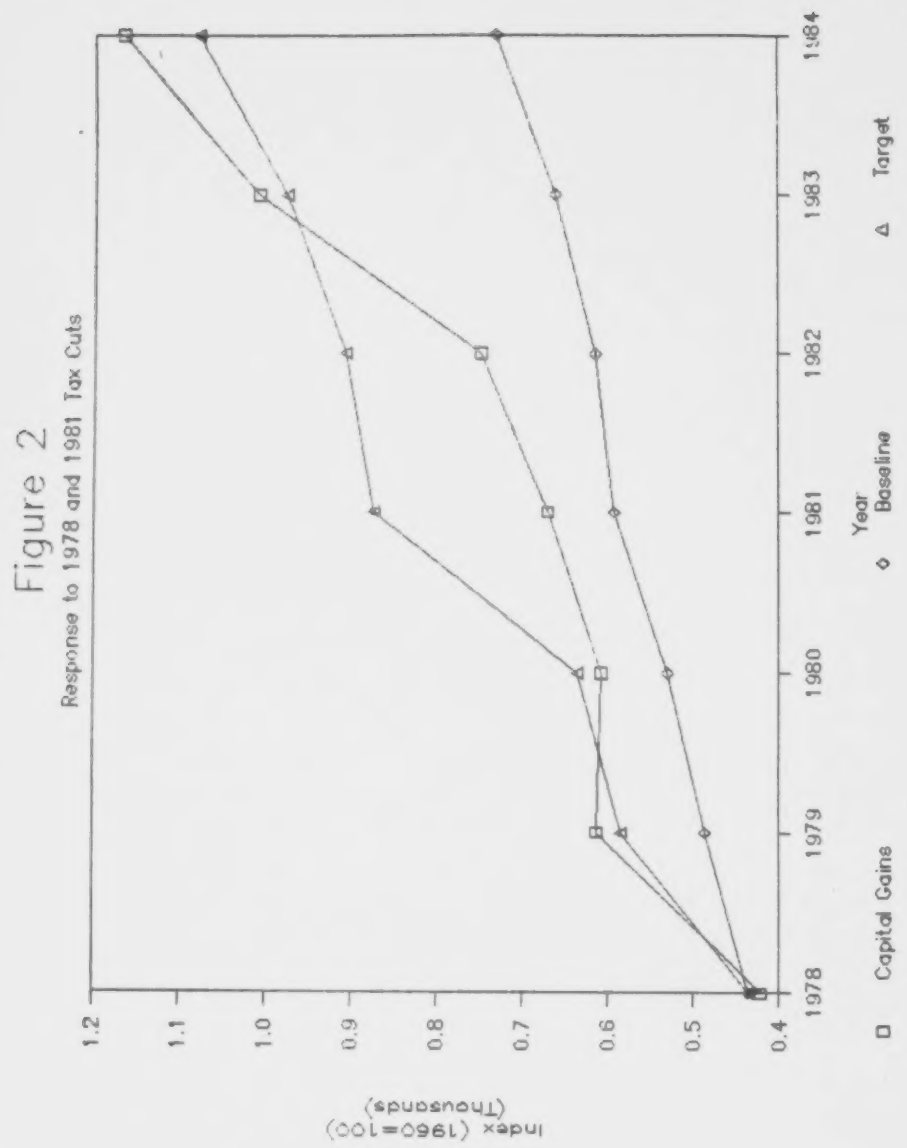
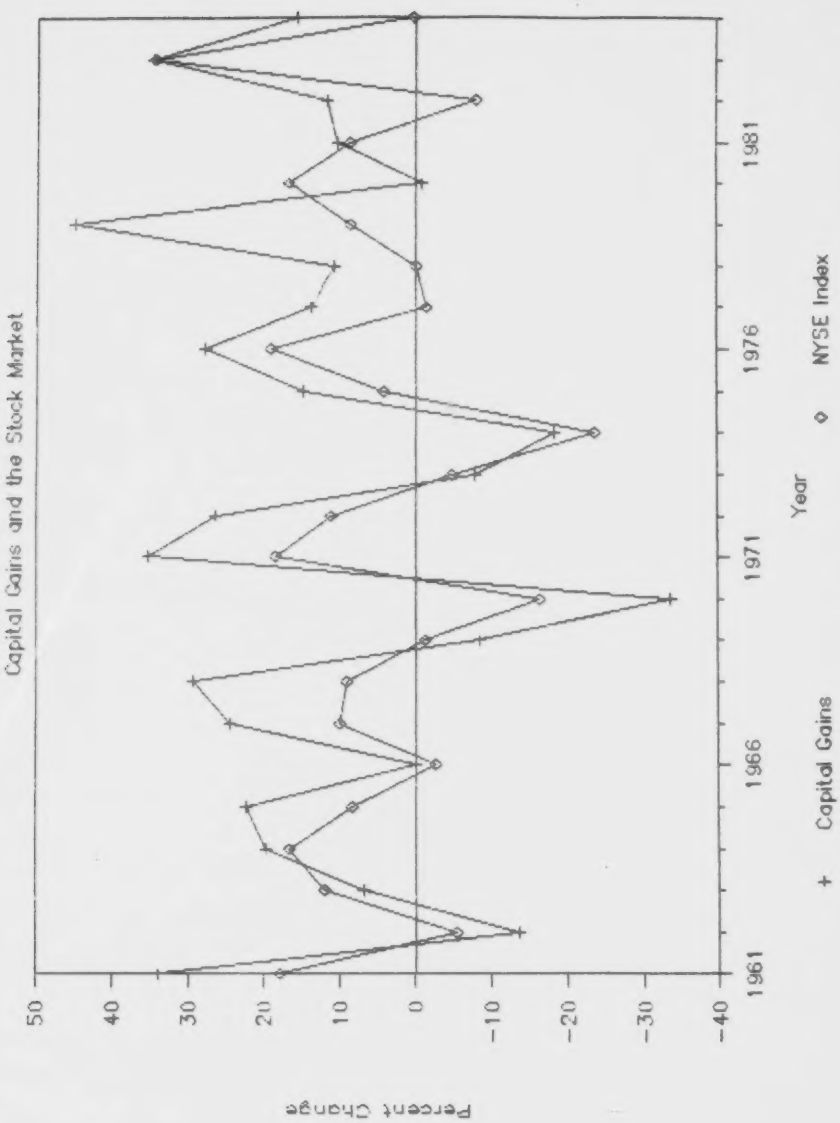


Figure 2
Response to 1978 and 1981 Tax Cuts
Index (1960=100)
(Thousands)
1.2
1.1
1.0
0.9
0.8
0.7
0.6
0.5
0.4
1978
1979
1980
1981
1982
1983
1984
Year
Capital Gains
Baseline
Target

Figure 3

Capital Gains and the Stock Market



Mr. GIBBONS. Thank you.

Mr. Duncan.

Mr. DUNCAN. I have no questions.

Mr. GIBBONS. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. I would like to thank the panel. It was very enlightening.

Mr. Minarik, you say that you did predict that capital gains would drop when we cut the rate before, and that your data bore that out?

Mr. MINARIK. I said that capital gains revenues would decline as a result of the 1978 tax cut. And if you examine my written testimony, I had some graphs in there. Again, if you examine the Treasury's historical estimates of the effects of the 1978 law, I believe they are consistent.

Mr. SCHULZE. I remember Treasury's estimates. What you are saying, in effect, is that the change in capital gains rate does not affect behavior. Is that the bottom line?

Mr. MINARIK. No, sir. What I am saying is that a reduction in the capital gains tax rates increases realizations by an insufficient percentage to make up for the revenue lost because of the lower rate.

Mr. SCHULZE. Well, it just seems to me that historic data does not bear that out. I have a copy of the current Wall Street Journal article which talks about a $10 billion dent in the deficit and how States are jumping up and down with glee because of the bonus they are getting from additional capital gains. It seems to me that what we are doing when we create this kind of a bonus is at the same time creating a lock-in effect.

You disagree with that as well?

Mr. MINARIK. No, sir. The bonus that the States are talking about was because of the increase in realizations at the end of calendar year 1986. As I said, sir——

Mr. SCHULZE. Triggered by the action that we took, right?

Mr. MINARIK. If you present a taxpayer——

Mr. SCHULZE. Triggered by the action that we took?

Mr. MINARIK. If you present a taxpayer with the option of realizing a gain——

Mr. SCHULZE. Not triggered by the action we took? Was this bonus, was this action as a result of the passage of the Tax Reform Act?

Mr. MINARIK. Yes, sir, it was a result of the passage.

Mr. SCHULZE. All right. Now, go ahead.

Mr. MINARIK. If you present a taxpayer, as we did in 1986, with the option of realizing a capital gain in the end of calendar year 1986 at tax rates that are lower than they are going to be in calendar year 1987, if the taxpayer is on the fence as to realizing a capital gain, he is going to realize it in 1986. There is no question.

However, as I said, that is an entirely different question from saying if you do reduce the tax rates will there be a continuing increase in realizations year after year over the long haul? That is a different question.

Mr. SCHULZE. Well, I hear what you are saying, and I have read your study. But in the real world, let me tell you, there is such a thing as lock-in effect. And as one who has taken advantage of cap-

ital gains from time to time—I do not know whether you have—but it certainly is an incentive to get that money out and turn it over. I know we can attribute it to all other kinds of things, but I do not know how you can remove that incentive factor. I thank you for your testimony.

Mr. Bloomfield, I enjoyed your testimony. I agree with much of it. We had a little discussion. I do not know whether you were in the room a little earlier. We were talking about long range competitiveness. I asked some industrialist captains of industry in the United States of America whether they would like to see a little border tax of some kind to create a more level playing field in the international marketplace. Their response was only if there is a degree of reciprocity or exact reciprocity.

I know that you have been involved with this field for some time. Do you care to comment on that?

Mr. BLOOMFIELD. Mr. Chairman, could I also in a few minutes have an opportunity to respond to Mr. Minarik's comments?

Mr. SCHULZE. Sure.

Mr. BLOOMFIELD. With regard to your question, in my judgment, in the next several years, this country will have to engage in a serious debate on the pros and cons of a national consumption tax for many of the reasons articulated earlier today. If you are going to address the deficit and bridge that gap of spending at 24 percent and revenues at 19 percent, where are you going to get the revenues? I do not think you want to increase rates, and I do not think you can broaden the income tax base much further. So I would suggest that you are going to debate and this country is going to debate a consumption tax for purposes of deficit reduction.

Second, I would suggest the country is going to debate a consumption tax for purposes of competitiveness. I have read many of your statements, and most of us are aware that this country has higher taxes on capital than our competitors. We are one of the few industrialized countries which does not have a consumption tax as part of its fiscal arsenal.

Third, with regard to comments that Mr. Guarini and others have made, I think in the next administration there will be pent-up demand for more spending, whether it be for competitiveness, whether it be for infrastructure or for other purposes. I would therefore suggest that a consumption tax is something this committee and the Congress should look at for all those reasons.

Mr. SCHULZE. I am somewhat encouraged and discouraged. I am not an advocate of larger taxes. I would like to see a consumption tax because of the international aspects, but I would also like to reduce taxes commensurately in order to make up for that. I would hope we would not just use it as a source of income for greater spending.

You also wanted to comment on capital gains.

Mr. BLOOMFIELD. I would, like to make four brief comments on Mr. Minarik's testimony. As you and we look at all the econometric studies and the various models, it seems to me we should ask the following bottom line question: Let us compare the record, since 1978, of Government revenues with the predictions of the various models.

There is one model that more accurately than others predicted what would happen after 1978, and that is the model of Dr. Feldstein with whom many of you are familiar. There was not only a transient, one-time unlocking, but a permanent higher level of capital gains realizations and revenue. Capital gains receipts have gone from $9 billion in 1978 to $26 billion in 1985. It was not just an unlocking in 1979. It was not just another unlocking in 1980.

Let me also add that Dr. Minarik points out that there are other factors that are important for realizations. He tries to track capital gains receipts with economic growth and with changes in the stock market. Let me just particularly address the point he makes about the stock market.

Capital gains realizations increased in the period 1978 to 1985 by a factor of almost 250 percent. The Dow Jones index over that period only increased 92 percent. What I am suggesting is, sure, there are a lot of factors, but let us return to the basic question. Which one of these studies, which one of these models makes the most sense in terms of the record?

Second, I am not only relying on Dr. Lindsey's work. The national accounting firm of Peat Marwick took all of Dr. Lindsey's studies and added several others, including a CBO study and a new Treasury study. What did they conclude? It turns out that Peat Marwick's analysis of six studies corroborated almost exactly the tremendous revenue losses that Dr. Lindsey predicts will occur as a result of the 1986 capital gains changes.

Third, if one, for purposes of being conservative—drops the high study, the Feldstein study, and drops the low study, a new CBO report from the Peat Marwick Survey—in other words, takes out the extremes—what does one find? One finds that Dr. Lindsey's behavioral response, his model, fits smack in the middle.

That being the case, I would suggest that his prediction of what would happen if you reduced the capital gains tax to 15 percent probably is a conservative, moderate approach. It suggests that such a proposal could raise $15 billion over 3 years.

Finally, let us go back to the actual Treasury numbers. There was a tremendous increase of 184 percent in capital gains tax receipts from $9 to $26 billion coinciding with a dramatic slash in the maximum capital gains tax from 50 to 20 percent in the period 1978 to 1985.

Mr. SCHULZE. I thank you. Thank you, Mr. Chairman. We have not given the others opportunity, but I will yield back the balance of my time.

Mr. GIBBONS. I am sure they will have an opportunity before it is all over.

Let us see. Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

Let me turn first to a discussion of the transaction tax. There has been some discussion about the effect of a transaction tax in discouraging a carryover of securities. I have been reading a very interesting book by David Halberstam lately which compares Japan and the United States, and seems to make the point rather dramatically that much, or at least a significant part, of our uncompetitiveness vis-a-vis Japan arises from the fact that our stock markets take a very short-term outlook in that American business

managers, manufacturing managers, reflecting that concern, tend to go for bottom-line, short-term profits at the expense of research and development and investment and other means which might make them more competitive in the long run.

We happen to have a trade deficit of $170 billion. I ask you whether that should not be a concern of ours and whether it might not be a healthful phenomenon if investors were caused to stop and think once or twice before turning over their holdings.

Mr. O'BRIEN. Would you like me to try that, Mr. Pease?

Mr. PEASE. Yes, please.

Mr. O'BRIEN. I also read Mr. Halberstam's book and found it very interesting, but the fact is that an investment account is really a custom tailored situation. Whether it is going to be a long-term account or a short-term account is something which has to be determined in each particular instance.

The fact is that taxes have a profound effect on investment decisions quite apart from any matters involving short-term or long-term programs for investment or orientation on it, for that matter, on the part of either investors or investor managers.

I also think that the long-term versus short-term orientation is more applicable to the commercial world rather than to the financial world. In other words, there is this short-term orientation, which was very applicable in the automobile business, which is what Mr. Halberstam was talking about, and has now been changed, we hope.

So I think that the real point is that we are convinced from our professional judgment that not only will it inhibit people in making investment decisions, both the individual and also their managers, but by the same token it will simply not produce the results because what they can do is to get around it.

What I see is the most profound change in my 30 or so years involved in the industry which is the internationalization. My own son, who is in the business, is receiving calls from Japan in the middle of the night, and the answer is that that business can go and is going around the world through technology rather easily. And a STET would really make that quite easily done.

Mr. PEASE. I appreciate that answer.

You know, of course, that we are required to raise $19.3 billion, and excise taxes appear to be leading contenders to make up a part of that package.

If we have to increase excise taxes, in terms of fairness, would we be better off creating an excise tax on securities transfers, or would we be better off increasing excise taxes on beer and wine and cigarettes, and that sort of thing?

Mr. O'BRIEN. Let me start again.

I think a tax on consumption would be more far preferable to a tax on securities transactions.

Mr. PEASE. In terms of fairness?

Mr. O'BRIEN. Well, in terms of fairness, and also in terms of worthwhile bottom line for the U.S. Government and the Treasury in getting in revenues.

Mr. PEASE. How so in terms of fairness?

Mr. O'BRIEN. Well, I think that there is, in the sense of the consumption tax, the individual has the freedom to move or not to

move. There is the freedom on both sides. So I would say that it is equally—I would put them on an equal level.

Mr. PEASE. Thank you. I find that interesting.

Let me turn now briefly to capital gains, and I'd like to thank Mr. Minarik in particular for coming and providing us with some objective information which hopefully will slow down the juggernaut that is moving along toward reducing the capital gains rate.

A primary tenet of the tax reform bill last year was fairness. And I wonder if you, Mr. Bloomfield, could comment on where the concept of fairness fits in to reducing the capital gains tax?

Mr. BLOOMFIELD. Let me start out by saying the thrust of my entire testimony has been on revenue impact and fairness. I have not made the capital formation case for capital gains which is, I think, also important.

What I am suggesting is that if you decrease the capital gains tax, as I indicated, to 15 percent, the question is where does that revenue come from? Dr. Lindsey, who is an associate of Prof. Martin Feldstein analyzed the distributional impact by income class of a 15 percent rate. If you assume Dr. Martin Feldstein's assumptions about the revenue implications, you will find that of that additional $31 billion in revenue that comes in, 80 percent will come from taxpayers with incomes of $100,000 or more; 40 percent will come from taxpayers with incomes of $200,000 or more.

Mr. PEASE. Let me interrupt you since my time has almost expired.

Those people then will be paying, the people over $100,000 and over $200,000 will be paying 15 percent on that gain rather than 28 percent.

Now, where is the fairness of that?

Mr. BLOOMFIELD. The fairness is that that money would not have come in without the reduction. You wouldn't have had the unlocking.

In my testimony, you will find similar data on the experience of the 1978 reduction. The additional revenue that came in as a result of the 1978 came from upper income people who realized capital gains or otherwise would not have.

Mr. PEASE. I thank you.

Thank you, Mr. Chairman.

Mr. GIBBONS. We are in a dilemma.

Mr. MCGRATH. Mr. Chairman, I have just two observations.

Mr. GIBBONS. Go right ahead.

Mr. MCGRATH. Mr. O'Brien, on the stock transfer tax, do you remember back, some years back when the Mayor of New York tried to institute a stock transfer tax?

Was not the attitude of the New York Stock Exchange at the time to move to Connecticut or New Jersey?

Mr. O'BRIEN. That's correct, Mr. McGrath.

As a matter of fact, I was very much involved in that situation. And firms actually did move across the river into New Jersey because of that.

Mr. MCGRATH. Well, let me ask you this question.

Wouldn't the same kind of thing occur now if we instituted a national stock transfer tax with the technology available today that

the stock markets would just go offshore, and we wouldn't be able to collect any of the taxes anyway?

Mr. O'BRIEN. The answer is that it's very simply done technologically today.

Mr. MCGRATH. Yes, I think that answers those questions.

Mr. Bloomfield, why is it that every time that joint tax gives us—during the proceedings of these bills, gives us a different picture than what you portray in terms of revenues gained by reductions in capital gains taxes?

Last year, we got a revenue gain by increasing the taxes from them. Why is this inconsistency between seemingly two smart outfits, yours and all the econometric models that you portray and the Joint Tax Committee?

Mr. BLOOMFIELD. It is my understanding that there are no public numbers available from the Joint Committee on the capital gains revenue impact of the 1986 reduction. They were not disaggregated from general rate reductions. So I cannot comment on their numbers.

With regard to the 15 percent proposal described in the Joint Committee pamphlet, you will note that there is no accompanying revenue estimate.

It is my understanding that all parties concerned recognize a fundamental disagreement about the revenue impact of capital gains tax changes. That disagreement is as follows:

It is my understanding that most of the Government revenue estimators, and probably the model that Mr. Minarik refers to, assume that there is not a permanent reduction in capital gains receipts if you increase the tax too much. In other words, it is not a permanent effect; it is just a temporary effect.

Second, the Government estimators do not believe that taxpayers are as responsive to capital gains tax changes as do the academics.

But right now I do not think there is a major disagreement between the Joint Committee and those who support the 15 percent solution on the revenue impact because the Joint Committee numbers are not out yet.

I did point out what Treasury's position is.

Mr. MCGRATH. Thank you for your testimony.

Mr. MOODY. Now I apologize to the witnesses that so many members had to run out to vote, and we will have your testimony, of course, in the record.

Mr. Archer wants to inquire, but while we're waiting, let me ask Dr. Minarik to comment on Mr. Bloomfield's comments regarding the difference in the models and where there may be legitimate methodological differences or philosophic differences or how can these studies be so at variance with your own study?

Mr. MINARIK. Thank you very much, Mr. Moody.

Let me say, first of all, Mark said he had four comments on what I had to say. Let me speak to what I think is the central one.

Point No. 1, Mark said, let's look at the models out there and see which one predicted the behavior after the 1978 capital gains tax changed best. And that was Marty Feldstein's model.

OK. What did Marty Feldstein's model predict? Marty Feldstein's model predicted that after the 1978 capital gains tax cut, capital gains realizations would immediately triple, immediately

triple. Six years later, after two additional capital gains tax cuts, capital gains realizations have still not tripled. OK.

Mr. MOODY. In real terms you're saying?

Mr. MINARIK. In nominal terms.

Mr. MOODY. In nominal terms.

Mr. MINARIK. In nominal terms. The capital gains realizations in 1978 before the law passed were not quite $50 billion. Capital gains realizations in 1984 were about $135 billion.

Mr. MOODY. OK. Mr. Bloomfield says if you disregard that study and look at the others, and disregard the CBO which was at the low end, and if you look at the other cluster of studies, you still have significant revenue effect, and how do you respond to that?

Mr. MINARIK. OK. Let me make a comment on Professor Lindsey's paper which Mark says was the one that came in in the middle of that range and, therefore, was the most accurate one.

First of all, I should say there are a lot of questions about cross-sectional analyses of capital gains behavior. There's a new Congressional Research Service paper by Jane Gravelle coming out addressing these questions that I think would be very important for the committee to consider.

Mr. MOODY. Do you think longitudinal is more important than latitudinal cross-sectional studies?

Mr. MINARIK. Well, the time series examinations, such as the Treasury did in their study, after the fact, looking at the effects of the 1978 law, I think are very important as confirmation of conclusions from the cross-sectional analyses.

And as I said in my testimony, Treasury found that there was essentially no revenue impact from the 1978 tax change after one year, and that the 1981 tax change was a revenue loser from day one.

So, as I say, it's important to take both these kinds of considerations in mind.

But let's look at Larry Lindsey's paper. Professor Lindsey's paper, the one in which he made his predictions with respect to changes in capital gains, has the following point to it: if you were to increase capital gains tax rates by 13 percentage points, and he has an average capital gains tax rate pre-1986 law of less than 15 percent, so, by increasing capital gains tax rates to 28 percent, according to Professor Lindsey's paper, that would end capital gains realizations altogether.

Now, that, I think, is an outlandish result. In order to come up with the results that he did in his paper, he changed it.

Mr. MOODY. Say that again. If you increase them by 13 percent, you would eliminate the net revenue effect?

Mr. MINARIK. You would eliminate capital gains realizations, period.

Mr. MOODY. You feel it would be totally locked in?

Mr. MINARIK. That's right. There would be no capital gains realizations.

Mr. MOODY. But that's not central to his paper, is it? I haven't read the paper, but it certainly isn't his central point.

Mr. BLOOMFIELD. Mr. Moody, can I just interject here? You're the only economist on the committee so you will probably appreciate it.

Both Dr. Minarik's comment on Dr. Feldstein and Dr. Feldstein's comment on Dr. Minarik are to be found in the Quarterly Journal of Economics, February 1984.

Mr. MOODY. Thank you. I'll try to read that before we meet again.

Mr. MINARIK. I have a copy for the record, sir.

Mr. MOODY. Thank you. QJE, February 1984.

Mr. BLOOMFIELD. That's right. We both have copies annotated.

Mr. MOODY. Good. Battle of the QJE citations.

Mr. MINARIK. So the point is this, Mr. Moody. Take that study. How are you going to simulate the effects of the 1986 tax law if it says that there are no realizations?

Well, as I said, Professor Lindsey, he was even-handed. He changed my results when he put them into his simulation model. He changed his own too. He did exactly the same thing. He picked a taxpayer in a particular situation, looked at his projected change of realizations, and estimated that everybody would do the same thing. And in so doing, he made his findings less outlandish. And I have to say that I don't know if it's coincidence or not, but in the course of making that alteration to the results that he actually ground out of his computer, he managed to put his study in the middle of the ranking with respect to their expected revenues.

Mr. MOODY. Well, you say he treated it as though every taxpayer acted identically.

Wasn't this an econometric study of the usual sort?

Mr. MINARIK. What he did, Mr. Moody, he fitted an equation across all taxpayers. Then he computed an estimated elasticity for one particular class of taxpayers.

Mr. MOODY. I see. And he assumed——

Mr. MINARIK. He computed everybody up and down the income scale, up and down the wealth scale——

Mr. MOODY. He assumed constant elasticity response for everybody regardless of income, is that your statement?

Mr. MINARIK. That's right.

Mr. MOODY. OK.

Mr. MINARIK. And the point is, with respect to my study, which was nonlinear, which allowed for those kinds of changes, and even with respect to his own study, what he was doing was making assumptions and putting this into the computer to simulate the revenue effects that he didn't have to do.

It was the computer making these computations. There was no need to rip the guts out of my equation. There was no need to rip the guts out of his equation.

Mr. MOODY. All right. Well, obviously this gets fairly arcane, and I look forward to communicating with both of you after I've had a chance to look at these.

Mr. BLOOMFIELD. Mr. Moody.

Mr. MOODY. Yes.

Mr. BLOOMFIELD. I only was made aware of Jane Gravelle's study last week. I talked to Professor Lindsey and he will respond to Jane Gravelle.

Mr. MOODY. All right. Thank you. I appreciate that.

Let me turn for a second to Mr. O'Brien.

Before I do that, I'm sorry. Mr. Bloomfield, Mr. Minarik, or any others who want to reply, you know there's been a great deal of talk before this committee about not changing the tax rates because of the "compact effect of the 1986 change."

How would changing the capital gains tax fare under that criteria of the compact effect? Would that be a violation of the compact?

Let me ask Mr. Bloomfield. Would there be a problem? Would this be a violation of the compact to change the capital gains rate?

Mr. BLOOMFIELD. I would not think it would be a violation, because the capital gains provisions are left intact in the Internal Revenue Code. And this committee has to raise revenue, I would suggest that this is probably the best way to do it.

Other things might violate that compact worse.

Mr. MOODY. All right. A quick 1 minute or less answer.

Mr. MINARIK. I just say it would lose revenue, so it means you're going to have to raise revenue somewhere else. You're more likely under that additional pressure to violate the compact in some other way.

Mr. MOODY. So we get back to the question of methodology.

I have one question for Mr. O'Brien, and then I'm going to turn to Mr. Duncan.

Mr. O'Brien, you said that having a transaction excise tax would jeopardize U.S. competitiveness position in the trading of securities, is that not correct?

Mr. O'BRIEN. Yes, sir.

Mr. MOODY. I'm sorry. I'm not intimately familiar with your argument yet because I was out of the room. Unfortunately we've had to move back and forth today. But pardon me.

Don't other industrialized countries have a transfer tax on securities?

Mr. O'BRIEN. They do exist in some countries, Mr. Chairman, and I refer to a good part of that in my written statement.

But it's also true most recently in the United Kingdom where they did have one. They've reduced it rather substantially as part of their deregulation. And it has proved to be rather workable and to produce the good result for them.

And we see other evidence around the world. So I think that it would be going in the wrong direction from our standpoint is what I'm saying.

Mr. MOODY. Right. But my point is only that in terms of losing transactions to offshore financial centers, to non-U.S. financial centers such as England or Japan, my understanding is that those markets also have transaction taxes.

Mr. O'BRIEN. But I think considerably lower. And I think what I'm saying is that it's crucial for us to maintain our competitive position here in the United States.

We have today three worldwide market centers, one in the United States, one in Japan, and one in the United Kingdom. And I think it's very important for us to make sure we take good care of ourselves.

Mr. MOODY. Right. So you would say that proposals you've seen would raise us above the transaction taxes that exist currently in those other market centers; is that correct?

Mr. O'BRIEN. Yes.

Mr. MOODY. We used to have one, of course, and then, of course, before deregulation, transaction costs used to be higher until they were deregulated, and they have come down.

Was there a period of time when, due to fixed fees for transactions and/or other reasons, our transaction costs were substantially higher than other money centers, or have we always been at rough parity with them?

Mr. O'BRIEN. I draw a blank on that. Maybe Mr. Chapman has the answer or one of my—I'll try to find the answer for you.

Mr. MOODY. I'd appreciate it because I think there's been periods before deregulation, as you know, we had fixed fees and they were higher. And then, of course, we had a transaction tax ourselves at one point.

So it would be interesting to look at that time as to what we were facing in other financial markets.

Mr. O'BRIEN. You're quite right. We had the elimination of those fixed fees in 1975, and we'll take a look at that.

Mr. MOODY. Thank you. I'd appreciate that.

All right. Mr. Duncan will inquire.

Mr. DUNCAN. I have just one question, Mr. Chairman, other than to thank the panel. It's been one of the best ones we've had here in a long time.

But one of the selling points of last year's Tax Reform Act was that it would push the Tax Code in the direction of value neutrality. That is, we would broaden the base by eliminating tax incentives that destroy investment decisions.

In effect, that would, we said then, create a level playing field. But doesn't the imposition of new excise tax simply place us back on the path of a value laden Tax Code that seeks to direct human behavior?

Anyone of you may respond, if you wish.

Mr. CHAPMAN. Let me try first.

I think I indicated in my testimony that I felt that way, that imposing a STET would create an artificial influence. It would tend to have a locking in effect. It would fall unevenly, in that it would fall equally in terms of its impact on transactions that earn a profit and transactions not at a profit. It would be a heavier tax on the income from a transaction as the income fell, rather than as it went up. And I think it would have that effect.

Mr. DUNCAN. And also would a new excise tax have impact upon revenues for State governments? We're hearing from some of the State Governors now that excise tax has been sort of within their domain to increase or decrease. And they thought they might lose revenue if the Federal Government usurps all of the avenues of excise tax.

Mr. O'Brien.

Mr. O'BRIEN. I've heard some of that, Mr. Duncan. I guess it puts you in a very difficult position of being in confrontation with them.

I only feel that the STET, or transfer taxes, is both unnatural and complicating, unduly complicating a situation. And as with many things in life, if people can find a way and have at their disposal a way to evade it or avoid it, however you wish to call it, they will probably try to do that.

And as I mentioned to Mr. McGrath, I think the technology makes that possible.

Mr. DUNCAN. Wouldn't it be a little simpler if all States had the same tax, excise tax on equal amount. I know in our State that we have the fourth largest alcoholic beverage tax in the Nation. And I told the President one time we used to make our own, and if they kept increasing the tax, they were going to drive us back that way.

But thank you though very much.

Thank you, Mr. Chairman.

Mr. MOODY. Thank you, Mr. Duncan.

Mr. Archer will inquire.

Mr. ARCHER. Thank you, Mr. Chairman.

So the panel will know where I'm coming from, I am the sponsor of a proposal to reduce the capital gains tax to 15 percent. And I believe very strongly in it, and if that makes me biased, then the panel should know of my bias.

I want to address most of my questioning to Mr. Minarik.

There's been a lot of exchange about whether we would get more revenue because of the unlocking effect, or whether there was such a thing and that type of thing. And I suppose that will be argued a good bit when we get into executive session as it's been argued between you and Mr. Bloomfield today.

But there's another aspect of revenue that seems to me is important in this, and I'm curious as to your evaluations, Dr. Minarik. I said mister because that's what's on your nameplate, but I know you are a doctor.

Mr. MINARIK. I'm not the only one at this table, sir. I don't know why I'm the only one on the sheet of paper.

Mr. ARCHER. But, in any event, I ask you if, in your analysis of revenue, whether you have taken into account the macroeconomic effect of having more capital more flexibly exchanged in the generation of more economic activity and more productivity.

To carry it back to basics, for example, except for capital and the implementation of adequate amounts of capital effectively and efficiently, we would still be back with the mules plowing 40 acres of ground. We wouldn't have the revenue to tax from an income standpoint.

Now, if in fact there are people who have investments, and have had them over a long period of time, and they face a high capital gains rate, and they look at their rather inefficient producing capital, they are still better off to leave it there than to sell it and have less capital to invest, which they might be able to invest in a more productive and a more efficient way.

And I'm wondering if the productivity of capital and the increased productivity that would come as a result of a freer exchange of capital is something that you have taken into account in your revenue estimates. Because that doesn't come under the capital gains rate, that comes under the ordinary income rate.

Mr. MINARIK. Well, I'd have to say, sir, the effects of taxation on the accumulation of capital and the investment in more efficient capital are not confined to the capital gains tax.

Let me point out just a couple of additional forces that are going on here, for example.

Some people say that a lower capital gains tax which encourages corporations to retain earnings so that the income that they generate is passed on to shareholders in the form of capital gains is a good thing. The retained earnings means there's more investment.

However, you will also find economists decrying the notion that income can be retained within corporations that have high current profits but don't necessarily have the best investment options at their disposal; that that income does not go out and pass the market test again and be reallocated to other businesses that might be able to invest it more efficiently.

Mr. ARCHER. Let me just interject at this point.

You've gotten over into the taxation, as I understand it, of capital gains to corporations. I'm talking about taxation of capital gains to individuals primarily, and I'd like at this point limit it to that if we can.

Mr. MINARIK. Well, a lot of the capital gains that individuals accrue are on corporate stock or are on interests in unincorporated businesses.

What I'm saying is that here we have a capital gains—

Mr. ARCHER. But that does not relate to retained earnings of corporations. I think you're building a smoke screen around all this and I'd like to get back to the core of what I asked you.

Mr. MINARIK. Well, I certainly did not intend to blow a smoke screen. Let me get to the point of what I was trying to say there.

We have in the Tax Reform Act of 1986 a package, which includes a lower corporate tax rate, a lower tax rate at the individual level on dividends, and a higher tax rate on capital gains which happens to be identical to the tax rate on dividends.

What I'm suggesting to you, and part of this hinges on the dispute between Mark and myself as to whether this is a revenue productive change or not, looked at from my point of view, where reduction in capital gains tax rates is a revenue loser, I know those revenues have got to come some place else.

One of the proposals in the course of the discussion of the Tax Reform Act of 1986 was a higher tax rate on ordinary income in exchange for a lower tax rate on capital gains.

What I'm suggesting is if you go that route, if you inhibit dividend finance, if you perhaps even lean toward the higher tax rate on corporations, I think that, net, you might be worse off from an efficiency point of view.

So what you're saying, Mr. Archer, is suppose we could wave our hands and have a lower tax rate on capital gains. Would we be better off? I'd like lower tax rates on everything if I could, but I don't think you can get there. I don't think it's free.

In my opinion, if we reduce tax rates on capital gains, we're going to lose revenue, we're going to have to make it up somewhere else. And I'm afraid that the round-trip is going to be an efficiency loser.

Mr. ARCHER. OK. And you have in-depth studies in that regard that take into account the added productivity increases or declines that would occur in the way of a dynamic exchange in the economy and its impact on ordinary income. You've taken all of that into account in your analysis, is that correct?

Mr. MINARIK. There's a long literature with respect to the revenue, the efficiency losses having to do with retentions of corporate earnings as opposed to reinvestment. It's the literature that backs up, for example, the arguments for integration of the corporate income tax with the individual income tax, whereby all income would be attributed to shareholders. You might have a lot of——

Mr. ARCHER. No. I know there have been a lot of studies on a lot of different things.

My question is intended to be precise relative to your presentation to this committee today on the income from taxation that would occur as a result of lowering the capital gains tax rate to individuals. And I asked you whether that had taken into account the dynamic interchange between capital invested in one place and capital investment somewhere else, the amount of capital to be invested, the dynamics as to the production of income which is the major source of revenue for this country at this time. And what net effect that would have, looking at the overall picture and not just the isolated picture on the capital gains rate.

That's specifically my question. I don't think you ever answered it.

Mr. MINARIK. If you're asking about your own particular papers——

Mr. ARCHER. Yes.

Mr. MINARIK [continuing]. The answer is no.

Mr. ARCHER. All right. Thank you. Thank you very much. That's what I wanted to hear. Thank you.

Mr. MOODY. Mr. Daub will inquire.

Mr. DAUB. Mr. Guarini.

Mr. MOODY. Yes. I'm sorry. Mr. Guarini will inquire.

Mr. GUARINI. Mr. Chapman, you spoke about excise taxes and gave all the reasons why you would be against it, their being regressive in the security industry.

Do you feel that way about excise taxes also in regard to items like tobacco and gasoline and telephone tax, and various other types of excise taxes? You give a very good summary of why we shouldn't have excise taxes. Do you feel that's true about those other items?

Mr. CHAPMAN. I was commenting on what I thought were the disadvantages of going to a securities transaction excise tax. But that's a different kind of tax.

Mr. GUARINI. Why does it hold over to the regressivity of other types of taxes, that excise tax itself?

Mr. CHAPMAN. I don't see us losing our competitiveness to the international community from increasing some of those other excise taxes.

Mr. GUARINI. All right.

Mr. CHAPMAN. So I don't see it as a direct analogy.

Mr. GUARINI. OK. Now, in regard to the capital gains tax, I understand, according to the IRS study, that 44 percent of the capital gains taxes up to about two years ago was not even collected. And a lot of reports were made, not necessarily from the security industries, it was probably through land and different real estate sales. And that's one of the areas of compliance that cries out the loudest.

Mr. Bloomfield, you mentioned that people over $100,000 would be the ones that would be hit if you brought your capital gains down to 15 percent.

Now, that means, I assume, that more money would be made by the wealthy people in frequent transaction turnovers. And that you would then have the rich getting richer?

In other words, would there become a greater disparity of wealth between the very rich and the ones that would be turning it over to make that kind of money, accelerate the market, raise prices on the marketplace, possibly cause instability in the marketplace at a time already when we have very unstable markets whose fluctuations from day to day are extreme?

And I'm just wondering whether or not you feel that a good social purpose would be attained even if we do gain more revenues? On the other side of the ledger, would we be the loser as a society?

Mr. BLOOMFIELD. There are several goals in tax policy. One is simplicity, one is efficiency, and one is fairness.

I am not that concerned about some upper income people keeping a proportion of their capital gains, at the same time the Government gets more revenues.

Mr. GUARINI. You would be concerned about stability of the markets and the market getting out of control?

Mr. BLOOMFIELD. I'm sorry, sir. I didn't understand that part of the question, markets getting out of control.

Mr. GUARINI. Would it cause more stability in the marketplace or would it cause market prices to be further accelerated and, as a result, possibly cause less stability than we have even now?

If you lowered the capital gains rate, then people would be exchanging their winnings in the marketplace very frequently. There is no longer a long-term or a short-term gain. They can turn it over on a daily basis. And if there's no loss at all, hardly any tax. I could see a marketplace that would be very quickly accelerated.

Mr. BLOOMFIELD. Well, I personally would encourage more mobility of capital. The concerns that people have—Mr. O'Brien and others perhaps could address this—about chaos on the various exchanges can be addressed other ways.

I think it important to encourage as much mobility in capital as you can.

Mr. DAUB. Would the gentleman yield to me for a minute?

Mr. GUARINI. Yes.

Mr. DAUB. I favor the installing of a capital gains rate at 15 percent. I think the people who take extraordinary risks ought to have an opportunity for extraordinary reward. But I like the gentleman's suggestion, the chaotic relationships that are now occurring, everything from triple witching to buy and sell on the same day. The idea of capital formation and savings is being impaired in my view.

So, coupled to it, if the gentleman would support a capital gains idea, might be this idea that the longer you hold it, the better the break. And you might get some kind of a scale in there of better reward.

Mr. GUARINI. In other words, go back to the days that we required people to hold on to the stocks for a given period of time, whether it be 1 year or 6 months or whatever.

Mr. DAUB. It could be if you hold it for 6 months, if the gentleman would further yield, x amount; if you hold it for a year, x amount. And then if you had it for 5 years, there would be an even better break. And then you give some stability to this whole idea of interest rates and the way in which money now moves in so many different ways than it did before we deregulated interest rates.

Mr. GUARINI. Now, there was a reason for holding for a six-month period.

Mr. BLOOMFIELD. Excuse me, Mr. Guarini. I——

Mr. GUARINI. And I assume that reason was to, you know, keep people from just rapidly turning over and propelling the stock market into insanity.

Mr. BLOOMFIELD. Mr. Guarini, my understanding of the 15-percent proposal, as the Joint Committee looked at it, and as the academics looked at it, would have a 6-month holding period. In other words, it is the existing capital gains structure except you are incorporating a flat capital gains tax rate.

So my understanding of the proposal, and my support of the proposal would probably include a holding period of 6 months.

Mr. MOODY. Would the gentleman yield for a second?

Both Mr. Daub and Mr. Guarini might be interested to know that their idea could be embodied by indexing the basis so that the longer you held it, it would be free from the inflationary gains which tend to drive it up unnecessarily.

By indexing the base, which was the Treasury proposal at one time, you in fact neutralize it with respect to length of time held in many ways.

Mr. GUARINI. What do you do about indexing? Is that a sound proposition of security?

Mr. BLOOMFIELD. No. My problem with indexing is that deals with one part of the capital gains problem which is the inflation part. It does not take into account Mr. Daub's point about encouraging risk taking.

Mr. GUARINI. Now, just a philosophical note. Should our society be a society that, to a coal miner or a farmer or a carpenter who is working by the sweat of his brow, should have to pay twice as much taxes on his earning power than a person who is clipping coupons, inherited great wealth, and just plays the capital money markets?

Do we put a greater value on coupon clipping or on people who work by the sweat of their brow? There's a message in there somewhere because we're talking about dollars. And are we going to evaluate in our society hard earned dollars by the work of an individual to be worth one-half in the sense of our tax policies than the man who just clips the coupon?

Mr. MINARIK. I would like to speak to that, if I could, Mr. Guarini.

Mr. GUARINI. Yes.

Mr. MINARIK. Part of the question here, when we're talking about a 28-percent tax rate on capital gains, I think has to be, compared to what? I mean if we go back prior to the 1981 tax bill, go back to the 1978 tax bill, the maximum tax rate on capital gains was 28 percent, I might add, in an environment much more infla-

tionary than the current one, and the capital markets erupted with glee.

Now, we're at 28 percent. And suddenly this is becoming a stratospheric tax rate.

I think you have to put that into that kind of perspective. And I think there really is a fairness issue here. We have pulled down the tax rates on very high income individuals to about a third of where they were only a decade ago. And I think that's marvelous. We've broadened the base, at the same time we're collecting about the same amount of revenue.

But to suggest then that we need to push the capital gains tax rate down still further, I think after all of that progress in reducing rates already, I think might be just a little bit excessive from the point of view of the fairness of the working man who's working in a 28-percent bracket looking at the person who's turning over assets at a 15-percent rate.

Mr. BLOOMFIELD. May I make one point about this fairness——

Mr. MOODY. Mark, please keep it brief. We have four more panels. And this is a terrific discussion, but we do have a time problem so why don't we wind this up.

Mr. O'BRIEN. Before we leave this, Mr. Chairman, I hope Mr. Chapman and I will have the opportunity to make a few comments about the folklore involving the market and its chaotic condition and some of these other subjects.

Mr. MOODY. Well, we do have a time crunch. Would you like to submit that for the record?

Mr. GUARINI. Mr. Chairman, your being an economist, I think that you may want to give a little leeway for an extra minute or two to our distinguished guests.

Mr. MOODY. All right. Mr. Bloomfield will respond, and then we will hear from our two other gentlemen, and then we will close, if possible, this section.

Do you want to inquire?

Mr. BLOOMFIELD. Is it fair, Mr. Guarini, that somebody who inherits a lot of wealth and has T-bills, is taxed at the same rate, takes no risks, as somebody who takes risks and invests in a new entrepreneurial activity? Do you want that same type of tax to apply to those same two options?

I think not. And that is why almost all of our international competitors do not tax capital gains as heavily as we do.

Mr. MOODY. All right. Mr. O'Brien.

Mr. O'BRIEN. Well, just briefly, the folklore, as I call it, about the chaotic conditions of the market, I think is nothing more than folklore.

The fact is that the markets have been able to run today on enormous volume, 150, 160, 200 million shares. Clearance and settlement, which was the concern of this Congress 15 years ago is not the issue any longer.

It is also true that the so-called triple witching hour chaos has not turned out to be chaos at all. It has worked out quite well.

So I think that those points really have to be kept in mind.

I was particularly interested, and want to note again for the record, Mr. Guarini's comment about compliance with capital gains. It's about 85 percent in the securities industry, Mr. Guarini.

Mr. GUARINI. I understand it's much higher than real estate.

Mr. O'BRIEN. Yes. It's quite good. And why is the market boiling? I'm not going to say whether it will continue to boil or why it's boiling, but I think it has little or nothing to do with triple witching hour or anything of that nature. It's because we've had a major change in our country in terms of taxation, compliments of this committee and the Congress, and I might also say earnings are generating the market.

Now, Mr. Chapman may have more to add on the subject.

Mr. MOODY. Mr. Chapman, do you agree with that, or do you have more to add?

Mr. CHAPMAN. I would agree with that, and I would suggest that we would save some time if we submitted several recent studies on volatility in the markets to the committee which indicate volatility is lower now than it used to be.

Mr. MOODY. We will be happy to look at those, and thank you.

[Material submitted by Mr. Chapman is maintained in the committee files.]

Mr. MOODY. Now Mr. Dorgan may inquire.

Mr. DORGAN. Mr. Chairman, let me, just very briefly, say to Mark Bloomfield that I have not read your testimony and was not present for the delivery of it, but intend to read it this evening.

I'm interested in the capital gains area. I indicated yesterday that there is, in my judgment, reason for us to investigate a narrow band of capital gains for the development of venture capital. I would like to look at that.

I don't have the same enthusiasm for a broad capital gains approach that I think is probably implied in your testimony. I worry frankly that predictions of lowering rates and, therefore, yielding much more revenue to the Federal Government generally do not come through, and that the previous capital gains experience was not due to such an incredible growth and activity that produced more taxes but, in fact, a flurry of activity by people who are trying to figure out how they could convert ordinary income into capital gains income at a lower rate. So, you see reported substantially more gains income and less ordinary income.

But I am going to read carefully your testimony. It appears to me to be very thoughtful testimony.

Mr. O'Brien, I wanted to mention one item. I am interested in the issue of the stock transfer tax. When I say interested in, not from the standpoint of I think we ought to adopt one or not adopt one. I don't know. I don't know very much about that.

I note in your testimony that you've described what's happening in England and Japan. I would also be interested in any further information you have about that, because I think it's something that's now on the table and now open for discussion, something that's of interest to me, and again not from the standpoint that I favor, but I want to explore it because it's one of the options.

Mr. O'BRIEN. I'd be very glad to furnish some additional material to you.

Mr. DORGAN. As much information as you can provide me with respect to the activities in those countries that now do impose some kind of a stock transfer tax, I'd really appreciate getting that information so I can review it.

Mr. O'BRIEN. Very good, sir.

Mr. DORGAN. Mr. Chairman, I yield back the balance of my time.

Mr. STARK [presiding]. I thank the gentleman.

Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

I just wanted the panel to know that when the chairman of the committee asked us for revenue options, I sent to him my suggestion that lowering the capital gains rate would be a revenue raising option rather than a loss of revenue. I think if you look at the history, and the revenue numbers, I think, without question, the case has been made.

I would also urge Mr. Guarini, in a couple of panels following, when we get to the Employee Stock Ownership Association, it may be a beautiful opportunity to combine sweat equity with capital equity so that workers can also enjoy the fruits of entrepreneurialships. I think there would be a combination that can be brought forward before the day is out.

But I wanted this panel to know at least there's one member who's been working on this and has studied it, and is convinced that it's the proper way to go.

Mr. STARK. I want to thank the panel for their participation, and appreciate your testimony.

The next panel consists of Ms. Grace Ellen Rice, the associate director of the Washington Office of the American Farm Bureau Federation; Mr. James L. Powell, the chairman of the Tax and Credit Committee of the National Cattlemen's Association.

I'd like to recognize Mr. Daub to introduce the remainder of the panel.

Mr. DAUB. Thank you very much, Mr. Chairman.

While the current panel leaves their desk and the new panel finds their name tags and takes their seats before the committee, it's my privilege to introduce several of the members.

This afternoon it's my pleasure to introduce three panelists who are here advocating farm tax legislation that will decrease the deficit, require no new taxes, close a major tax loophole for a select few corporate giants, offer a level playing field to industries that compete every day on the same field, return accounting to a provision intended to benefit the true small family farmer, and continue our efforts to keep the tax shelter farmer out of farming which, of course, leads to overproduction and lower commodity prices.

Mr. Chuck Hassebrook will speak on behalf of the Center for Rural Affairs, an agriculture research and analysis center located in Walthill, Nebraska. Chuck is an experienced tax analyst and an important advocate of the American farmer. We've worked together over the last few years, with the help of many others, to try to develop a farm tax policy that makes sense for the family that is trying to farm. And I feel there have been great strides made in this direction, particularly with the passage of last year's Tax Reform Act.

Speaking on behalf of ConAgra Poultry Co. is their president, George Haefner, who will be accompanied by Mr. Elbert Thomas, Jr., the vice president of the Federal Co. Both these men represent companies which are currently suffering from a competitive disad-

vantage because companies in direct competition with them are able to take advantage of the cash accounting loophole.

Although not from my home State, I would also like to extend a warm welcome to my friends from the Farm Bureau and the Cattlemen's Association, Grace Ellen Rice and James L. Powell.

Finally, I have brought with me a collection of articles, Mr. Chairman, on the much publicized cash accounting loophole. I would like to ask the chairman's permission to enter all of these articles into the record.

Mr. STARK. Without objection.

[The articles follow:]

Taxing Matters

When is a $1 billion agri-industrial complex a family farm? When it comes time to pay the income taxes.

Fun and games with chicken feed

By Keith Glover

MOST REASONABLE observers would not call Hudson Foods a family farm. Based in Rogers, Ark., Hudson is now the country's 17th-largest poultry producer. In the fiscal year that ended last Sept. 28, Hudson earned $8.5 million on sales of $185 million. It went public in February, raising $21.3 million.

Your basic family farm? The Internal Revenue Service, not always a reasonable observer, thinks so. As a result, Hudson was able to defer $7.6 million, its entire federal tax bill, last year under long-standing IRS rules. This deferral can be rolled over more or less indefinitely.

Hudson is not a fluke. Other agri-industrial complexes, including $1.1 billion (sales) Tyson Foods and privately held Perdue Farms (estimated sales, $740 million), also routinely receive tax breaks originally intended for family farms. How? By qualifying under some rather arcane rules that allow "family farms" to use cash accounting instead of the accrual accounting the IRS requires most companies to use when computing taxable income. The rules date from 1919, when the Treasury concluded farmers weren't sophisticated enough to use accrual accounting and said they could use cash accounting instead. Big farmers didn't abuse the provision, because taxes were low. Besides, there weren't many big farms.

The choice of cash or accrual is especially important for livestock farmers because such production costs as feed are incurred well before the livestock is sold.

Consider a chicken farmer. Accrual accounting would require him to report a portion of his feed inventories at the end of each year, while not permitting him to expense the feed until the bird was actually sold. The theory is that the feed is an integral part of the cost of producing the bird. Accrual accounting says income and expenses should be matched, so feed costs should not be deducted until revenue is received.

Cash accounting, in contrast, allows the farmer to report cash expenses and receipts when they actually occur. That means the farmer can immediately deduct the feed as an expense, but he doesn't have to report the chickens as income until they are sold. Expensing in the current period while deferring income to a later period amounts to a tax-free loan to the farmer from the Treasury. The bigger and more profitable the farm, the larger that tax-free loan tends to be.

In 1976 the Treasury argued that agribusinessmen were equipped for the rigors of accrual accounting. Treasury tried to limit cash accounting to farmers grossing less than $1 million annually. That sent the big livestock producers squawking to their congressmen, who chickened out. Even a farm grossing $1 billion or more could be a "family farm," Congress said, if at least 50% of its stock was controlled by a single family. It also carved out exceptions for individuals, partnerships and Subchapter S corporations and for farm corporations controlled by two or three families.

Hudson Foods Chairman James Hudson played those loopholes with the skill of Stephane Grapelli on jazz

Chickens before the slaughter

The bigger and more profitable the farm, the larger the tax-free loan. . .

violin. Hudson, a former Ralston Purina executive, and two other investors bought the business from Ralston Purina in 1972. Hudson bought out his co-investors in 1984, and took the farm public in February.

But note the key: Hudson Foods has 12 million shares outstanding. James Hudson owns outright 7 million of those shares, 58%, and has the right under a revocable proxy to vote an additional 3 million shares owned by his family and company executives. With Hudson effectively controlling 10 million shares—83% of the common—Hudson Farms can do several more public offerings and still qualify as a "family farm."

Hudson cheerfully agrees: "It's been a long, long time" since he drove a tractor. But, he says, "Farming, as defined in the tax code, is the production of farm products. It doesn't matter whether you ride a tractor or a horse." In other words, says Hudson, all farmers are created equal and should be treated equally by the IRS.

Springdale, Ark.-based Tyson Foods, the nation's second-largest poultry producer (after ConAgra), is also proving adept at playing by the family farm rules. This $1.1 billion agricompany contracts out chicken production to thousands of small farmers, and it derives more than 60% of its revenues from such "further processed products" as Chicken McNuggets and frozen dinners.

To remain a family farm—but also raise public equity—Tyson recently reincorporated in Delaware, where it can issue two classes of stock. The Tyson family will trade its 55% Class A holding for restricted Class B shares that carry ten votes each. Outside shareholders can keep the Class A shares or swap them for Class B, which pays a lower dividend. If only the Tysons make the switch, they will control 92% of the voting rights—far above the magic 50% minimum. Any new stock issued by Tyson will be of the Class A variety.

Important? It is to Tyson. Tyson earned $35 million in the fiscal year that ended Sept. 28. Cash accounting allowed it to defer about $26 million in taxes. That amounted to 78% of Tyson's 1985 federal tax bill.

"We consider ourselves as an umbrella over about 6,000 farms and farm families," says Chairman Don Tyson, defending his use of the family farming rules. "If we didn't have this kind of situation, we couldn't protect those 6,000 farmers."

But do family farmers need such protection? The fact is, cash accounting often works against farmers by making cattle, hogs and certain orchards attractive tax shelters and by encouraging overproduction. "I've seen too many instances where egg producers or others on a cash basis will expand their operation to avoid paying income tax," says Agriculture Secretary Richard Lyng, who was briefly on Hudson Foods' board. "That kind of tax policy has caused family farmers a lot of trouble."

Chuck Hassebrook of the Center for Rural Affairs in Walthill, Neb. agrees. "Cash accounting," he warns, "really distorts supply and demand." And Tyson may soon freeze the amount it defers because tax factors are warping its business decisions.

This seems like just the kind of loophole genuine tax reform should plug. Indeed, the Administration's reform proposals would have limited cash accounting to companies with less than $5 million in gross receipts. But the big farmers and their lobbyists squawked as in 1976, and congressmen again clucked. Reforming farmers' cash accounting was one of the first proposals to be dropped last year by congressional tax writers. ■

The Washington Post August 8, 1986

Family Farm Tax Break Aids Big Poultry Firms

Congress Is Urged to Revise System

By Dale Russakoff
Washington Post Staff Writer

David Mayer, a North Carolina farmer with 150 acres of row crops and four chicken houses, is a typical beneficiary of a tax break created by Congress decades ago to protect and encourage family farms.

But because of a technical wrinkle in the tax code, the family farmers' break also benefits some of the nation's biggest poultry producers, including:

- Tyson Foods, the nation's largest poultry producer with more than $1 billion of sales last year. Tyson used the break to defer $26 million, more than three-fourths of its 1985 tax bill.
- Hudson Foods Inc., the No. 17 producer, which deferred $4 million.
- Perdue Farms Inc., Frank Perdue's Eastern Shore poultry empire. (Perdue, as a private company, is not required to disclose its taxes.)

"I guarantee you if that interpretation was brought forth in the public, it would reflect bad on all these congressmen and senators in these farm states who let it happen," Mayer said in a telephone interview.

As a House-Senate conference committee hammers out a tax bill aimed at closing loopholes and lowering tax rates, an unlikely coalition is pressing the lawmakers to wipe out the family farm break for all farms with gross sales over $100 million. This would raise $500 million over five years, according to congressional estimates.

It is not just small fry who are squawking. The nation's No. 2 and No. 3 poultry producers, ConAgra and Holly Farms, which do not qualify as family farms, are arguing that this break gives their competitors the equivalent of a golden egg.

"The small farmer is the guy the law was intended to protect and to help, and he's the person we want the law to apply to," said Elbert Thomas, financial vice president of the Federal Company, parent of Holly Farms.

"It seems to us that it is a fairness issue," said Martin Colladay, vice president of $6-billion-a-year ConAgra, producer of Country Pride chicken.

Thomas and Colladay estimated that 10 to 20 corporations selling more than $100 million a year of farm products enjoy the "family farm" status. Based on the congressional estimate, this puts the break at $25 million to $50 million per company.

The tax code defines a family farm as one in which three or fewer families control at least half the stock. Since the Hudson and Tyson families control more than half the stock in Hudson and Tyson Foods, they qualify as "family farms."

The benefit lies in the firms' accounting systems. Most big corporations are required to use a sophisticated technique in which no costs are deducted until income is received. This prevents corporations from "sheltering" income at the end of the tax year by increasing inventories or buying supplies and deducting the costs.

Family farms are exempt, on the theory that they lack "skilled accounting assistance," as Congress noted in a 1978 tax law update. They deduct expenses as they occur and declare income when it is received.

It is generally agreed that the system helps the large "family farms" expand, encouraging them to buy large amounts of feed at year's end and build up their inventories of chicks. "In other words, spend it or pay taxes," said Bill Haffert Jr., editor of Broiler Industry Magazine.

Tyson general counsel Jim Blair said the firm's special status is justified because it acts as an umbrella for 6,500 small farmers, with whom it contracts to raise its chickens—providing all supplies from chicks to feed and medical supplies. Without the tax break, Blair said, the firm might not be able to extend as much protection, and many small farmers could be jeopardized.

Spokesmen for ConAgra and Federal said their firms extend almost identical contracts to chicken growers, without the tax benefit.

"It seems to me to be a very unusual loophole," said William Leach, a food-industry analyst for the investment-banking firm of Donaldson, Lufkin and Jenrette. "You have companies like Tyson with more than $1 billion in sales called a family farm and therefore paying very little taxes, while companies like Kellogg and Sara Lee are paying 40 percent."

When the Senate debated the tax bill in June, Sen. Edward Zorinsky (D-Neb.), who hails from the state where ConAgra is based, moved to close the loophole for big companies but ran into opposition led by Sens. David H. Pryor (D-Ark.), Dale L. Bumpers (D-Ark.) and William V. Roth Jr. (R-Del.)—all from states where Tyson, Perdue and Hudson are prominent.

Farmers' breaks helping poultry producers

The Washington Post

WASHINGTON — David Mayer, a North Carolina farmer with 150 acres in row crops and four chicken houses, is a typical beneficiary of a tax break created by Congress decades ago to protect family farms.

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Spokesmen for ConAgra and Federal said their firms extend almost identical contracts to chicken growers — without the tax benefit.

"It seems to me to be a very unusual loophole," said William Leach, a food-industry analyst for the investment-banking firm of Donaldson, Lufkin and Jenrette. "You have companies like Tyson with more than $1 billion in sales called a family farm and therefore paying very little taxes, while companies like Kellogg and Sara Lee are paying 40 percent."

When the Senate debated the tax bill in June, Sen. Edward Zorinsky, D-Neb., who hails from the state where ConAgra is based, moved to close the loophole for big companies but ran into opposition led by Sens. David Pryor, D-Ark., Dale Bumpers, D-Ark., and William Roth Jr., R-Del. — all from states where Tyson, Perdue and Hudson are prominent.

COLUMBIA, MO
TRIBUNE
D. 16,868 SUN. 19,652
SAT. 16,807

AUG 9 1986
BURRELL'S

TULSA DAILY WORLD
TULSA, OK
D. 132,790 SUN. 226,250

AUG 9 1986
BURROUGHS

Family Farm Tax Breaks Benefit Large Agribusinesses

By DALE RUSSAKOFF
The Washington Post

WASHINGTON — David Mayer, a North Carolina farmer with 150 acres of row crops and four chicken houses, is a typical beneficiary of a tax break created by Congress decades ago to protect and encourage family farms.

But because of a technical wrinkle in the tax code, the family farmers' break also benefits some of the nation's biggest poultry producers, including:

— Tyson Foods, the nation's largest poultry producer with more than $1 billion of sales last year. Tyson deferred $26 million, more than three-fourths of its 1985 tax bill.

— Hudson Foods Inc., the No. 17 producer, which deferred $4 million.

— Perdue Farm Inc., Frank Perdue's Eastern Shore poultry empire. (Perdue, as a private company, is not required to disclose its taxes.)

"I guarantee you if that interpretation was brought forth in the public, it would reflect bad on all these congressmen and senators in these farm states who let it happen," Mayer said in a telephone interview.

As a House-Senate conference committee hammers out a tax bill aimed at closing loopholes and lowering tax rates, an unlikely coalition is pressing the lawmakers to wipe out the family-farm break for all farms with gross sales over $100 million. This would raise $500 million over five years, according to congressional estimates.

It is not just small fry who are squawking. The nation's No. 2 and No. 3 poultry producers, ConAgra and Holly Farms, which do not qualify as family farms, are arguing that this break gives their competitors the equivalent of a golden egg.

"The small farmer is the guy the law was intended to protect and to help, and he's the person we want the law to apply to," said Elbert Thomas, financial vice president of the Federal Company, parent of Holly Farms.

"It seems to us that it is a fairness issue," said Martin Colladay, vice president of $6-billion-a-year ConAgra, producer of Country Pride chicken.

Thomas and Colladay estimated that 10 to 20 corporations selling more than $100 million a year of farm products enjoy the "family farm" status. Based on the congressional estimate, this puts the break at $25 million to $50 million per company.

The tax code defines a family farm as one in which three or fewer families control at least half the stock. Since the Hudson and Tyson families control more than half the stock in Hudson and Tyson Foods, they qualify as "family farms."

The benefit lies in the firms' accounting systems. Most big corporations are required to use a sophisticated technique in which no costs are deducted until income is received. This prevents corporations from "sheltering" income at the end of the tax year by increasing inventories or buying supplies and deducting the costs.

Democrat & Gazette
September 7, 1986

Tax break benefiting Tyson kept

Bumpers, Pryor lead fight to retain quirk

By Carol Matlack
GAZETTE WASHINGTON BUREAU

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WASHINGTON — Tyson Foods of Springdale, Ark., is sitting on a golden nest egg: A quirk in the federal tax code intended to benefit "family farmers" that has enabled the world's largest poultry producer to pay virtually no income taxes during the last five years.

And, thanks to a fierce behind-the-scenes battle this summer by Senators David Pryor (Dem., Ark.) and Dale Bumpers (Dem., Ark.), the golden egg lives on in the sweeping tax overhaul bill of 1986.

Tyson, along with most of the country's big poultry producers, benefits from an obscure tax law that defines a "family farm," as any agriculture-related firm whose stock is controlled 50 per cent or more by three or fewer families.

Defers payment

Unlike most corporations — including an El Dorado, Ark., firm that is one of Tyson's biggest competitors — a "family farm" can defer paying a large share of its taxes if it stocks up on feed and other inventory at the end of each year. Tyson last year deferred $28 million, about three fourths of its tax bill, dropping its effective tax rate to only 6.1 per cent.

Country Pride Foods of El Dorado, the country's second-largest poultry producer, does not qualify for the break because it is owned by a conglomerate, ConAgra, Inc. Nor does Holly Farms, Inc., of Wilkesboro, N.C., the third-biggest producer.

In theory, firms that defer their taxes eventually must pay them. But in practice, so long as a company keeps expanding, the deferred sum grows larger and larger.

According to Tyson annual reports on file with the Securities and Exchange Commission, the company has averaged a zero effective tax rate during the last five years, with a negative tax liability some years because of credits and deductions. Hudson Foods of Rogers, Ark., another beneficiary of the "family break," deferred $4 million of its 1985 taxes.

"It's a boondoggle," William Lasch, a food industry analyst with the New York investment firm of Donaldson Lufkin Jenrette,

(See BREAK on Page 8A.)

said last week. "It gives companies like Tyson and Hudson an unfair advantage."

According to the National Broiler Council, 31 of the country's 33 biggest poultry firms qualify for the "family farm" break.

'Shock absorber'

James B. Blair of Fayetteville, Tyson's general counsel, defended the tax break in an interview last week, saying it allowed Tyson to serve as a "shock absorber" against fluctuations in the poultry market, protecting some 6,500 small farmers who grew poultry under contract for the firm.

But Country Pride and Holly Farms have virtually identical contract-growing arrangements, and do not qualify for the break. "The impact on Holly Farms is that, for the same revenues and the same pre-tax income, we're paying more," said Allen Klots, a Washington lawyer who represented Holly Farms' parent Federal Company on tax matters.

Limit sought

During Senate debate on the tax-overhaul bill in June, Senator Ed Zorinsky (Dem.; Neb.), whose home state includes ConAgra's headquarters, proposed an amendment that would have limited the "family farm" break to companies selling less than $100 million a year of farm products.

But a small group of senators led by Bumpers and Pryor quickly squelched the proposal by threatening a Senate floor fight that

> "It's a boondoggle. It gives companies like Tyson and Hudson an unfair advantage."
>
> — William Leach
> food industry analyst

would have delayed — and, some felt, jeopardized — passage of the entire tax bill.

"You've never seen two senators work the Senate as frantically as [the two did when word got out," an aide to Zorinsky said last week. "They promised a royal battle, which [Senate Finance Chairman Bob] Packwood did not want to have." Packwood, an Oregon Republican, had supported the Zorinsky proposal, which would have produced an estimated $800 million in federal revenues over five years. However, he and Zorinsky agreed to withdraw the proposal under pressure from opponents, chiefly Pryor, Bumpers and Senator William V. Roth (Rep., Del.), whose home state includes Perdue's operations by Perdue Chicken, another beneficiary of the break.

'Willing to go to the mat'

"We were willing to go to the mat on this issue," Pryor said in an interview last week. "I frankly think if it came to a showdown vote on the Senate floor, we would have prevailed."

Pryor said the "family farm" break had been a key factor in the growth of the Arkansas poultry industry and he added, "I don't see [any] particular reason about it. "It's not to get out of paying taxes. It's basically just deferring." If firms like ConAgra and Holly Farms are unhappy, Pryor said they should seek legislation to expand the break to cover them and he would support it.

Bumpers, on the other hand, acknowledged that he "would hate to have to argue there is a reason" for Tyson, with more than $1 billion in annual sales, to qualify for a benefit originally intended for small farmers. "It's admittedly a bit of a tax break for them," he said. However, "I did exactly what any other senator would do" in defending home-state interests.

Unusual twist

But there was an unusual twist in this case: One of the most outspoken critics of the tax break, ConAgra, has its poultry operations based in Arkansas. Even Representative Beryl Anthony (Dem., Ark.), whose hometown of El Dorado is the headquarters of Country Pride, supported retention of the "family farm" break during House tax deliberations last year.

Bumpers and Pryor said that while they could understand ConAgra's distress, the vast majority of Arkansas poultry firms qualified for the break. Among them were Peterson Industries of Decatur, Simmons Industries of Siloam Springs and George's, Inc., of Springdale.

Blair, Tyson's general counsel, said that ConAgra was in no position to complain because it had

it's such an unfair advantage, why did ConAgra pay less taxes than we did?" (However, according to ConAgra's annual report, the firm paid $19.8 million in federal taxes last year, nearly five times what Tyson paid, and its effective tax rate during the last four years was about 10 per cent.) ConAgra officials could not be reached for comment last week.

Accounting systems

At the heart of the dispute are the accounting systems that corporations use in figuring their taxes. Most large corporations are required to use a complex technique called "accrual" accounting, which means they cannot deduct expenses incurred until they receive income. For example, a poultry firm using "accrual" accounting could not claim deductions for the cost of corn until the corn is fed to a chicken and the chicken is sold.

But Congress has said that farmers, on the theory that they lack "skilled accounting assistance," can deduct expenses as they occur. A poultry firm using this method can buy large quantities of supplies such as feed and chicks at the end of the tax year, thereby offsetting much of its tax liability. Although the deferred taxes must be paid when the income is earned later, the firm can repeat the procedure the following year, claiming an even larger deferral if it has expanded.

'Deferral is permanent'

"The deferral is permanent, so long as investment in inventories of birds and feed remains constant," Klein, the Holly farms lawyer, said. "So long as your inventories remain constant or grow, you never pay it back."

Klein said the "family farm" break ironically was hurting smaller poultry growers because large year-end purchases by big producers created "a distorted market for the little guy."

Leach, the New York food-industry analyst, said the arrangement encouraged concentration of the poultry industry in the hands of a few large companies. "At the end of the year, the more money they spend, the less taxes they pay," he said.

Arkansas poultry firms using the "family-farm" break have expanded dramatically in recent years, especially Tyson and Holly Farms, which have both announced acquisitions of smaller firms in the last few months.

Bumpers and Pryor acknowledged that the Arkansas poultry industry was thriving, as did Blair of Tyson, but they said the recent good times had come after years of hard work and adversity. "Nobody has had a harder, longer struggle than this industry has for 30 years," Bumpers said. "For the last two years, here's an industry that's finally doing well, and now they want to take [the tax break] away."

"The industry is healthy, but the federal government could ruin it if they set out to," Blair said. He noted that poultry growers received virtually no government subsidies, unlike most row-crop farmers who qualify for federal price supports.

used other tax loopholes. "Almost everybody in the world has some peculiar thing" that allows them to reduce their tax bills, he said. "If

393

HERALD-TRIBUNE
SARASOTA, FL
DAILY 87,183
MONDAY
SEP 8 1986
BURRELLE'S
217

Report Says Family-Farm Rule Lets Poultry Firms Defer Taxes

LITTLE ROCK, Ark. (AP) - Tyson Foods, the world's largest poultry producer, has paid virtually no income tax in the last five years due mostly to a tax code provision intended to benefit family farmers, a newspaper reported Sunday.

Tyson - as do 21 of the country's 25 largest poultry producers - benefits from a provision that allows a large tax deferral for family farms, the Arkansas Gazette reported.

Under the law, a family farm is defined as any agriculture-related firm owned by three or fewer families who control at least 50 percent of the company's stock. A family farm can defer paying a large share of its taxes if it stocks up on feed and other inventory at the end of each year.

Tyson, based in Springdale, Ark., has annual sales of more than $1 billion. Last year, Tyson deferred $26 million, about 75 percent of its tax bill, dropping its effective tax rate to 6.1 percent, the Gazette said.

Annual reports on file with the Securities and Exchange Commission show Tyson has averaged a zero effective tax rate during the last five years, with a negative tax liability some years because of credits and deductions, the newspaper said.

Hudson Foods of Rogers, Ark., which also qualified under the family farm provision, deferred $4 million of its 1985 taxes.

"It's a boondoggle," said William Leach, a food industry analyst with the New York investment firm of Donaldson Lufkin Jenrette. "It gives companies like Tyson and Hudson an unfair advantage."

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Country Pride Foods of El Dorado, Ark., the country's second-largest poultry producer, does not qualify for the break because it is owned by a conglomerate, Con-Agra, Inc. Holly Farms of Wilkesboro, N.C., the third-largest producer, also does not qualify.

In theory, firms that defer their taxes eventually must pay them. But in practice, so long as a company keeps expanding, the deferred sum grows larger.

During U.S. Senate debate on this year's tax overhaul proposal, Sen. Ed Zorinsky, D-Neb., proposed limiting the family farm break to companies with $100 million in annual sales.

MORNING NEWS

SAVANNAH, GA
DAILY 55,815

MONDAY
SEP 8 1986
BURRELLE'S

Largest Poultry Companies Slip Through Tax Loophole

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SEP 8 1986
BURRELLE'S

Tax code benefits poultry producers

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"Almost everybody in the world has some peculiar thing" that allows them to reduce their tax bills, Blair said.

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"The impact on Holly Farms is that, for the same revenue and the same pre-tax income, we're paying more," said Allen Klein, a Washington lawyer who represented Holly Farms' parent Federal Co. on tax matters.

In theory, firms that defer their taxes eventually must pay them. But in practice, so long as a company keeps expanding, the deferred sum grows larger.

"The deferral is permanent as long as investment in inventories of bird and feed remains constant," Klein said. "So long as your investment in inventories remains constant or grows, you never pay it back."

During U.S. Senate debate on this year's tax overhaul proposal, Sen. Ed Zorinsky of Nebraska, where Con-Agra is headquartered, proposed limiting the family farm break to companies with $100 million in annual sales.

A small group of senators led by Sens. Dale Bumpers and David Pryor of Arkansas, squelched the proposal by threatening a floor fight that would have delayed passage of the entire tax bill.

"We were willing to go to the mat on this issue," said Pryor. "I frankly think that if it came to a showdown vote on the Senate floor, we would have prevailed."

"It's admittedly a bit of a tax break for them," Bumpers said. "I did exactly what any other senator would do."

NEWS & COURIER

CHARLESTON, SC
DAILY 70,720

MONDAY
SEP 8 1986

BUBBELLE'S

26

Law Reportedly Lets Tyson Defer Taxes

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September 8, 1986 Boston Globe

Largest poultry producer reportedly escapes taxes

Associated Press

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In theory, firms that defer their taxes eventually must pay them. But in practice, so long as a company keeps expanding, the deferred sum grows larger.

THE NASHVILLE TENNESSEAN
NASHVILLE, TENN.
D. 123,455 SUN. 244,231

SEP 9 1986

BURRELLE'S

'Family farm' tycoons get tax breaks

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Follow-Through

Chickening out

Under the wing of an arcane tax law meant to benefit small farmers, even agricultural giants like $1.1 billion (sales) Tyson Foods, $740 million (estimated sales) Perdue Farms and $185 million (sales) Hudson Farms are "family farms." The rule applies so long as 50% of a company's stock is held by one family, and it saves those chicken farms millions each year by allowing them to use cash accounting rather than the accrual method, with which the IRS requires most other firms to compute taxable income. Tyson, for example, deferred $26 million—78% of its tax bill—last year (FORBES, *Mar. 5*).

There has been much squawking on the subject since the spring. Cash accounting often works against farmers by making livestock and some orchards attractive tax shelters and so encouraging overproduction. It also understandably ruffles the feathers of

Chickens before the slaughter
The IRS raises chicken feed.

publicly held competitors such as $5.5 billion (sales) ConAgra and $1.3 billion (sales) Federal Co., two chicken farms that, under the tax code, are not family farms and thus do not qualify for the tax benefits that cash accounting bestows. The companies lobbied Congress to limit cash accounting for farmers to those with revenues of less than $100 million. That would raise $500 million over five years, says the Joint Committee on Taxation.

It was not to be. Tyson, Perdue and Hudson formed the Family Farm Association and hired a premier tax lobbyist. Three chicken-state senators—William Roth Jr. (R–Del.), David Pryor (D–Ark.) and Dale Bumpers (D–Ark.)—also helped keep the Senate and conference committee from voting on the issue. "They twisted every arm that could be twisted," says one congressional aide.

Other proposals were weakened. Congress wanted a much longer depreciation period for chicken coops and hog pens than the five-year writeoff in current law. But the bill provides only a seven-year writeoff. "It maintains an incentive to overproduce in an industry with chronic overproduction and gives a strong advantage to high-[tax]-bracket producers," says Chuck Hassebrook of the Center for Rural Affairs in Walthill, Neb.

Agribusiness won't escape the new corporate minimum tax, of course. But what will the Treasury raise from those farms? Chicken feed.

Tax Reform: Congress Hatches Some Loopholes

'Transition rules' provide $10 billion in breaks

BRYAN HILL—SCIENCE

Will there be egg on any faces? *Perdue's poultry get special treatment*

The architects of tax reform—Rep. Dan Rostenkowski and Sen. Bob Packwood—have lately had a difficult time negotiating the Capitol corridors. Both have been waylaid by scores of lobbyists—and colleagues—who stuff a hand or empty coat pocket with sheets of paper. Each sheet was a "transition rule": a total or partial exemption from tough provisions in the new tax bill. Abandoning the old law abruptly, many lawmakers argue, would be too wrenching for some taxpayers. So by last week, when Bob and Rosty shipped the tax bill to the printers, they also sent along 350 transition rules with $10 billion in tax breaks. "The chairmen provided themselves with several billion dollars worth of grease that they could slather around to make sure they had enough votes to pass the bill," says an aide to Sen. Howard Metzenbaum. Whether it is grease or economic common sense, one thing seems clear: without the loopholes the tax bill would not be headed for almost certain passage. The winners:

■ **Chicken farmers.** Under the new tax law, businesses with sales over $1 million must figure their taxes by *accrual* accounting, in which revenues are recorded as they are earned, not *cash* accounting, in which revenues are recorded when actually collected—thus deferring taxes. The change could have hatched a tax increase for poultry conglomerates such as Frank Perdue's in Delaware (1985 sales: about $750 million) and Tyson Foods in Arkansas ($1 billion). But on Capitol Hill, Bob and Rosty were anxious to sign up Sens. William Roth of Delaware and Dale Bumpers and David Pryor of Arkansas. Those lawmakers got a rule excusing farm corporations *controlled by three or fewer families* from accrual accounting. Nearly all of the top 25 poultry firms happen to be controlled by three or fewer families. In all, the rule will deprive the treasury of $1 billion over five years.

■ **Steel companies.** This industry can use some help, and the tax bill grants it a $520 million bonanza—in cash. Sen. John Heinz of Pennsylvania won a transition rule that allows steelmakers to take advantage of the investment tax credit, or ITC, in which companies deduct from their taxes certain investments in new equipment. The new tax bill kills the ITC—except for the steel industry and a few others. In addition, Congress permits the mills to receive the credit without paying taxes first. To pay taxes, of course, you need profits, and the steel belt hasn't seen those in years. The rule will allow the industry to use the ITC for [illegible] years. (In another ITC gambit, Rostenkowski worked out a $300 million break for Commonwealth Edison, a Chicago utility.)

■ **Lawyers and accountants.** America's lawyers and accountants were, like Frank Perdue, slated to lose the benefits of cash accounting. Their lobbyists mounted a massive push that brought another exemption—this one permitting "personal-service businesses," e.g., lawyers, accountants and doctors, to use cash accounting. The lawmakers' concern was also personal. "Most congressmen are lawyers, and most of the staffers will sooner or later go to work for private law or accounting firms," says Robert M. Brown of Peat, Marwick, Mitchell & Co., an accounting firm.

■ **New York state.** Sen. Daniel Patrick Moynihan, a member of the powerful Finance Committee, attached *nine pages* of transition rules on the final bill. The New Yorker negotiated exemptions for long-planned construction projects at three of his state's universities, several power plants and the Merrill Lynch skyscraper. Moynihan's exceptions will save his public and private constituents $360 million in taxes.

■ **Phillips Petroleum.** Sen. David Boren of Oklahoma knew that the state's Phillips Petroleum Co. stood to be hurt by one provision of the new tax law: a 10 percent excise tax on money withdrawn from any corporate pension fund. Phillips, with an unusually successful pension fund, was planning to reallocate an estimated $1 billion—a move that would net the U.S. government roughly $100 million. Boren won a transition rule that exempts Phillips—and only Phillips.

■ **Corporate agriculture.** Senator Roth also secured a rule that will benefit the nation's largest farmers. One rule allows hog, dairy and poultry farm buildings to be depreciated at an accelerated rate. "This gives the big guys an unfair advantage," says Chuck Hassebrook of the Center for Rural Affairs. "The country spends $30 billion subsidizing crop production already, and we don't need loopholes."

But even tax-reform watchdogs found the loopholes an acceptable trade-off for passage of the bill. "It's not pretty," says Robert McIntyre of the liberal Citizens for Tax Justice, "but if it's the price we have to pay for this great tax-reform bill, so be it." Senator Metzenbaum was not so easily appeased. He promises to disclose a complete description of all the transition-rule deals. "Americans," says Metzenbaum, "are entitled to an explanation of why a few taxpayers should receive more favorable treatment than others who are in similar situations—but less influential." Whatever the merits of that view, there seems little chance it would imperil tax reform.

MARK D. UEHLING *with* RICH THOMAS *in Washington*

6 — FEEDSTUFFS, February 9, 1987

Tyson reports commitment to 'leading edge' of technology

SPRINGDALE, ARK. — Noting that the year was a year in which it became "the largest, fully-integrated producer, processor and marketer of poultry-based products in the world," Tyson Foods, Inc., has reported that its 1986 earnings and sales results were records. Tyson said that it strengthened its already dominant position in further processing poultry products for the foodservice and retail sectors, and said that it is "committed" to maintaining its leadership positions.

For the year ended Sept. 27, Tyson said that its net earnings totaled $50.3 million or $1.18 per share on revenues of $1.5 billion, compared with $34.8 million or 88 cents per share on sales of $1.1 billion in 1985 and with $18.2 million or 47 cents per share on sales of $750 million in 1984.

Tyson said that its results were helped significantly by the acquisitions of the Heritage Valley further processing plant in Van Buren, Ark., and the Lane broiler growing/further processing companies in Alabama, Arkansas and Oklahoma. Tyson said that the company paid $28 million plus $79 million in assumed liabilities for Lane and that both Heritage Valley and Lane facilities were extensively renovated in the year.

Additionally, Tyson said that it spent $110.9 million for other capital improvements and plant construction.

Tyson said that with its acquisitions and capital programs, the company now controls product quality from start to finish, operating 21 hatcheries, 16 feed mills and 31 processing plants and processing about 13 million chickens per week, or more than 2 billion pounds. The company employs 25,000 people and has grower contracts with more than 8,000 farmers.

Additionally, Tyson pointed out, the company's production is virtually all enhanced-value — meaning that there is at least some convenience measure added — and more than half is further processed — meaning that it's enhanced significantly. Tyson said that these products command prices based on added production values and have more predictable margins, as opposed to commodity poultry.

Accordingly, Tyson said, the company "is less vulnerable" to fluctuations in the grain and commodity poultry markets, and its success depends, rather, on internally controllable factors such as manufacturing costs, product quality, marketing strategies, customer service and new product development.

In its annual report, Tyson said that it introduced several new products last year for both the at-home and away-from-home markets and especially carved "a deeper niche" into the consumer convenience market with fully cooked, microwavable entree and snack products.

Tyson said that it plans to expand its market shares. Noting that its lines are the most heavily advertised poultry products in the U.S., Tyson said that it plans to increase its aggressive magazine, newspaper, radio and television promotions. Tyson also plans to increase its research and development.

"Innovation is the key to the future," Tyson said, and the company plans "to remain at the leading edge of technological advances" in poultry production, product development and marketing.

Tyson's annual meeting is scheduled Feb. 27 at the Continuing Education Center in Fayetteville, Ark. #

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If you want to keep your teeth for a lifetime, you should know that today's number one cause of tooth loss is gum disease, which will affect 90% of all adults. The primary factor in the development of gum disease is bacterial plaque, the thin, colorless film of bacteria which continually forms on your teeth and gums.

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Today Viadent remains the only toothpaste with a patented ingredient that prevents plaque. Viadent's effectiveness and safety have been proven in over 90 clinical and laboratory studies. Viadent goes beyond just brushing and flossing because it works between the teeth and gums to prevent the bacteria which form plaque. And Viadent's effectiveness lasts for hours after you brush.

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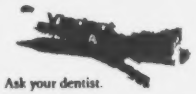
With both Viadent Toothpaste and Viadent Oral Rinse your teeth will be so clean you'll actually feel the difference—that's why 80,000 dental professionals recommend Viadent to their patients.

If you want to keep your teeth for a lifetime, be sure to visit your dentist regularly, brush and floss daily and change to Viadent to make your home care program more effective. Only Viadent contains a patented ingredient that prevents plaque.



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PLAQUE: The short story.

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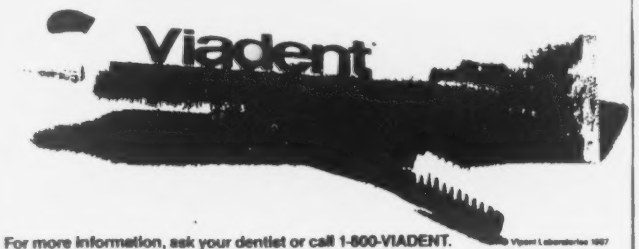

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IT'S YOUR $ MONEY

Federal credit, loan and subsidy programs designed to help struggling small businesses and family farms often end up helping prosperous large corporations. And the taxpayers are footing the bills

Time to End Corporate Welfare

By Rep. James Courter (R., N.J.)

In the Ozark foothills of northwestern Arkansas, Tyson Foods, the nation's largest poultry producer with 25,000 employees and $1.5 billion in annual sales, enjoys the status of a "family farm" under our tax code. The designation was created to help struggling farm families. Instead it enabled this Fortune 500 agribusiness giant to avoid paying $37.6 million in federal taxes in 1986—more than three-quarters of its entire tax bill!

Last year, in California's San Joaquin Valley, the J. G. Boswell Company, owner of over 85,000 acres of cotton, received $11.6 million in crop subsidies from U.S. taxpayers. General Electric benefited from more than $66 million in federal credits and guarantees in 1986, while Boeing was aided by $72.4 million in federal support for the sale of commercial aircraft to Japan.

These examples illustrate our largest, yet virtually unknown welfare program—aid for dependent corporations. The payoffs come in various forms: direct spending subsidies, loan guarantees, and tax breaks from special-interest provisions of the tax code. Many of these corporate-support activities are hidden in the federal budget and not voted on explicitly by Congress. Nor does accountability exist to assure that these subsidies offer any benefit to the country as a whole.

Loopholes are exploited across the spectrum of federal support activities. Programs intended for

READER'S DIGEST, June 1987

struggling independent firms are instead fattening the coffers of prosperous corporations. Each year the cost to American taxpayers of this corporate welfare is in the tens of billions, according to Congress Watch, a consumer-advocate organization. The group further estimates that we could be halfway to balancing the federal budget by 1988, *without* reducing military or social spending, just by eliminating corporate welfare.

Corporate subsidies raise fundamental issues of fairness. As economist William Niskanen, chairman of the Cato Institute, points out, "These subsidies to business—no matter what the amount—weaken our economy and exploit the American taxpayer."

Farm subsidies are among the most misused of the federal programs, benefiting large corporate farmers, often to the detriment of true family farms. The 1986 farm subsidy of $25.8 billion was about twice what Congress had initially appropriated. In 1985, 75 percent of the aid ended up in the pockets of the wealthiest 22 percent of farmers.

Among poultry producers, 21 of the 25 largest companies, including Tyson Foods, are designated as family farms, entitling them to generous tax breaks. "It is tantamount to giving some companies an interest-free loan, leaving those that can't qualify at a distinct disadvantage," complains Elbert Thomas, vice president of the parent company of Holly Farms, a poultry producer

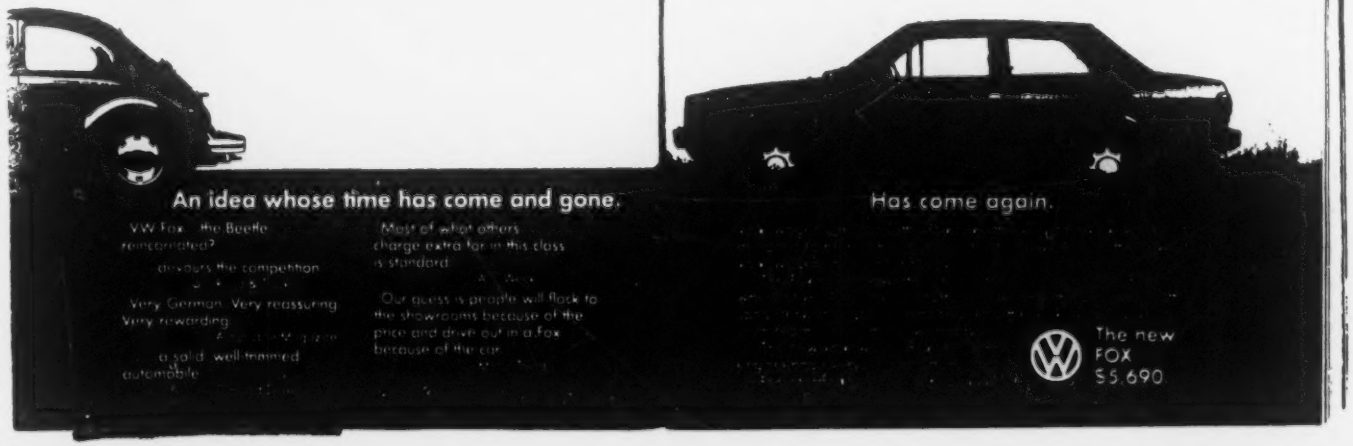
that doesn't meet the family-farm criteria.

Our farm policies have degenerated into an "Alice in Wonderland" situation complete with mazes, contradictions and absurdities. For example, to boost certain overseas sales of farm commodities, the Agriculture Department gives exporters a bonus in the form of government-held surplus crops. The exporter can then sell these to help offset any losses it may have incurred.

The surplus crops are sometimes worth more than the commodities exported. Last September, Egypt purchased 6000 tons of poultry at $875 a ton. The export company received surplus soybeans from the USDA worth $1210 for each ton of poultry sold. That meant U.S. taxpayers gave away $7.2 million in products.

Sugar producers enjoy one of the sweetest deals on Capitol Hill. The federal government guarantees an artificially high price for domestic sugar while restricting imports of cheaper foreign sugar. Result: prices for consumers that have at times reached almost *seven times* the world market price. Most of the benefits of $970 million in taxpayer-subsidized loans were reaped by a small number of huge corporations, including multinational firms from Britain and South Africa.

Washington also spends millions of dollars to encourage the growth and sale of tobacco, while at the same time it coughs up additional millions on anti-smoking campaigns—a clas-


An idea whose time has come and gone.
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Has come again.
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sic case of government fighting itself and achieving nothing but a loss of taxpayer assets. Americans underwrite tobacco production through loans and marketing quotas, with additional government largess in the form of inspection and grading services, research, market-news reporting and crop insurance.

It costs the Treasury more than $20 million per year just to administer these programs. At the end of 1986, outstanding tobacco loans totaled $2.3 billion, on top of an estimated $319 million in unpaid interest written off by the government.

Taxpayers can expect further losses over the next few years as tobacco inventory used as federal-loan collateral is sold off to cigarette companies like Philip Morris and R. J. Reynolds to partially repay the USDA. The government invested $2.6 billion in the crops and is selling its investment for $2 billion—a loss of approximately $600 million for the American taxpayer.

Government giveaways extend to heavy industry as well. Since the Depression, the federal government has created five Power Marketing Administrations and the Tennessee Valley Authority, which provide low-cost hydroelectric power in 34 states. Electricity generated by the TVA and the PMAs is priced an average one-third less than what other customers pay.

A primary beneficiary of this taxpayer-subsidized power is the aluminum industry. Some of the smelters have been owned or partly owned by foreign companies, primarily Canadian, Australian and Japanese. For example, Comalco Limited of Australia has owned aluminum plants in PMA-served areas of Kentucky, Washington and Oregon. Alcan Aluminium Ltd. of Canada also runs a smelter in Kentucky using PMA power.

Privatizing the PMAs and the TVA, selling them off to the private sector, would accomplish three worthy goals: 1) help alleviate the budget deficit (by as much as $100 billion, according to The Heritage Foundation); 2) establish a standard of fairness where no consumers receive subsidized electric rates at the expense of others; 3) end the enrichment of foreign corporations in the United States through low-cost power.

A recent goal of the government has been to improve the ability of U.S. firms to sell products overseas. The Export-Import Bank offers loans, loan guarantees and credit insurance, generally at low cost, that help firms dealing in foreign trade. In recent years, however, half of the bank's loans have gone to benefit just seven major corporations, most of them involved in the export of aircraft and power-plant equipment. These loans, most economic analysts concede, have little if any real effect on our balance of trade, and such subsidized exports actually harm those industries and compa-

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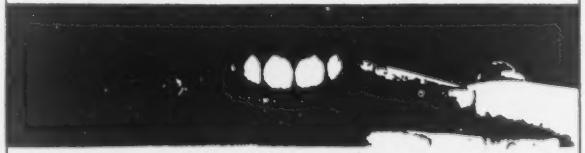

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nies that fail to receive assistance.

Still another program that frequently benefits large corporations is the Urban Development Action Grants administered by the Department of Housing and Urban Development. More than half of UDAG funding, intended to help economically distressed cities, has gone to support such commercial projects as hotels, office buildings and parking garages.

Since 1978, over $4 billion in federal aid has been pumped into the program, with major corporations among the beneficiaries. Nearly 300 federally subsidized hotels have been approved or constructed, almost one-third of which became Hiltons, Holiday Inns, Sheratons and Hyatts.

Unlike private banks, which measure success by profits, Uncle Sam has no standard to measure loan performance. A study of federal credit programs by the Office of Management and Budget recently concluded: "The federal government endures losses that would bankrupt private financial institutions. These losses are ultimately borne by taxpayers."

To control corporate subsidy programs, we in Congress must take at least three steps:

- *Make subsidies explicit in the budget.* The true annual cost of credit and loan guarantees should be clearly spelled out for each program.
- *Require a comprehensive fiscal-impact statement in proposed legislation.* Currently we do not know, for example, how and to what extent corporations benefit from programs ostensibly designed for smaller firms.
- *Enforce a periodic review of spending programs to determine their usefulness.* This would help provide a yardstick by which we could measure and then terminate unnecessary and outmoded corporate-support activities.

No matter what procedural reforms are enacted, a public outcry is needed to arouse the indignation of Congress to eliminate these corporate handouts. You can help by writing your Senators and Congressmen. Tell them that you will no longer tolerate government subsidizing of Fortune 500 companies at the expense of the taxpayers.

❋❋❋❋❋

No Problem

TAKING ONE OF the jungle-cruise boat rides at Florida's Wakulla Springs State Park, my wife asked the guide if he ever had trouble with snakes dropping into the open boat from overhanging limbs.

"Naw," he drawled, "no trouble. You got a snake in the boat, then you got people in the water. You got people in the water, you got alligators in the water. You got alligators in the water, you got people back in the boat. Ain't no trouble a'tall."

—Contributed by Gary Hayes

"When I stopped using soap and started using Dove, my face just wasn't dry anymore. I feel 10 years younger."
Gloria Carter, Los Angeles, Calif
"You know that tight, dry feeling you get after you wash with soap? I didn't feel that with Dove."
Junell Wingate, Wayzata, Minn
DOVE VS. SOAP
"Soap made me feel like I had a mask on. Tight and pulling. Dove is 100% better than soap."
Carol Vines, Atlanta, Ga
Dove
Dove doesn't dry like soap.
Because Dove isn't soap.

Mr. ANTHONY. Mr. Chairman.

Mr. STARK. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

I would like to join Mr. Daub in welcoming the panel, but a special welcome to George Haefner, who is from my hometown of El Dorado, AR, who does a superb job with ConAgra, and the community is very blessed to have the company there.

A warm welcome to Washington, DC, and we look forward to your testimony before the Ways and Means Committee.

Mr. STARK. I'm going to ask the panel if they will observe the lights. We will have plenty of time to let you expand on your testimony as the members inquire, and you may summarize your prepared statements or add to them in any manner that you're comfortable.

Ms. Rice, would you like to begin.

STATEMENT OF GRACE ELLEN RICE, ASSOCIATE DIRECTOR, WASHINGTON OFFICE, AMERICAN FARM BUREAU FEDERATION

Ms. RICE. Thank you, Mr. Chairman.

The American Farm Bureau Federation is a general farm organization. We represent virtually every commodity grown commercially in this country. We represent a variety of farm sizes and farm business situations, whether they are sole proprietors or partnerships or corporations.

We're active in 2,800 counties throughout the country and, as I said, represent three-quarters of the commercial farmers in the United States.

During the development of the budget resolution, we had advised the Budget Committees that the Farm Bureau did not support any tax increases to balance the budget. In the alternative, we had suggested across-the-board spending cuts in all areas of the Federal Government, including defense, entitlement programs, and agriculture. We believe that these cuts could have been made to meet the Gramm-Rudman-Hollings budget targets. But, as you know, Congress went another way, including a budget resolution that calls for around $65 billion in tax increases over the next 3 years.

And since the Ways and Means Committee is charged with drafting changes that meet these recommendations or reconciliation requirements, we would like to comment on particularly two revenue raising options contained in the Joint Tax Committee booklet.

The first one deals with estate taxes. Our members were quite active in 1976, and again in 1981, during the enactment of the Economic Recovery Tax Act, when we saw some significant estate tax reform. We are concerned that several of the revenue raising options currently before the committee would wipe out some of that reform that we achieved.

We are particularly concerned about efforts to reduce the unified estate and gift tax credit, the prospect of a carryover basis, and also the prospects of capital gains tax at death.

We are concerned because these points would affect farmland which has, although it's backed off a little bit in recent years in terms of its valuation the effects of inflationary gains built into it. These gains are unrelated to the productive capacity of the land.

And in many instances it's the same situation that you've heard about before: farmers facing the situation of having to pay taxes by selling off part of the farm property. So that is one of our major concerns.

Our statement indicates an example highlighting both the effects of carryover basis and capital gains at death. I won't go into that right now, but it does indicate the significant burden that can occur when you have either one of these tax provisions or proposals in effect.

We believe that, in addition to the higher tax bills that farmers and farm heirs would be facing, you face administrative problems for the executors, for the fiduciaries. There are evaluation problems simply because you may not have the original records that the purchaser had.

Liquidity problems can be severe, particularly in a time when we face many debt and income problems in agriculture.

And then, finally, there is a problem of double taxation of sorts when you have not only the estate tax burden to bear but also capital gains should the heirs decide to sell that property. Particularly important since, at the present time, capital gains are taxed at ordinary rates.

The other point I would like to mention quickly is the excise tax area. We have many farmers in the Farm Bureau who grow commodities that go into the development of alcohol and tobacco products, particularly tobacco. These taxes—the tobacco tax—have been increased in recent years. Higher taxes can have an adverse trickledown effect on individuals who grow these commodities because that represents lessened demand for the finished product and, therefore, fewer marketing opportunities for our farmers.

Our general comments would be that we understand the committee is looking at excise taxes which have a regressive nature. It hopes to balance those out with estate taxes which are more progressive in nature. But the fact remains that many farmers are caught in the middle, we are hit by both kinds of taxes, and we ask the committee to be mindful of that as well as the effect that higher gasoline taxes could have on agriculture.

We also hope the committee will keep in place the income tax reforms of the 1986 act.

And in closing, briefly I would say that our members have a great deal of skepticism about the entire issue of tax increases. Our farmers believe that tax increases won't go to reduce the deficit; instead, they will go to pay for more Government spending, which our members believe has caused our initial problem.

Thank you.

[The statement of Ms. Rice follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE HOUSE WAYS AND MEANS COMMITTEE
REGARDING TAX INCREASE OPTIONS

JULY 8, 1987

Presented by Grace Ellen Rice
Associate Director, Washington Office

The American Farm Bureau Federation is the nation's largest general farm organization with more than 3.5 million member families in 2,800 County Farm Bureaus throughout 49 states and Puerto Rico. Farm Bureau membership includes over three-fourths of the commercial farmers and ranchers in the country.

During the development of H. Con. Res. 93, the FY 1988 budget resolution, the budget committees were advised that Farm Bureau members do not support tax increases to balance the budget. Rather, we suggested an alternative of across-the-board spending cuts in all areas of government programs including defense, entitlements, and agriculture to meet the deficit targets of Gramm-Rudman-Hollings. As you know, Congress rejected this approach and instead approved a federal budget which calls for the enactment of almost $65 billion in tax increases over a three year period ($19.3 billion in 1988, $22 billion in 1989, and $23 billion in 1990).

The House Ways and Means Committee is charged with the responsibility of drafting tax changes to achieve higher taxes required in budget reconciliation. Among your options are several that affect farmers and ranchers, and we appreciate the opportunity to comment on these proposals.

ESTATE TAXES

Farm Bureau members were active in estate tax reform in 1976 and again in 1981 when Congress enacted the Economic Recovery Tax Act that provided significant estate tax relief for farm families. Several of the revenue raising options before the Committee would wipe out the estate tax reform achieved in the last decade. For example, a reduction in the credit that exempts $600,000 of an estate's value from taxation would hurt farm families. Although land values have fallen in the past few years, they have now stabilized at prices that continue to reflect previously inflated gains that are unrelated to the productive value of the land. Inflated gains cause higher estate valuations and therefore higher taxes that may force the sale of family farms to pay the taxes on the property.

A capital gains tax at death, or the imposition of carryover basis, would also tax inflationary gains unrelated to the productive capacity of the property. Farm and ranch heirs should not be forced to pay increased taxes on an artificial gain in land values, especially when the appreciation occurred prior to their ownership. The following example shows the burden of either capital gains taxation at death or carryover basis. Assume the decedent's original cost of an acre of land is $500 and worth $1500 at death. An heir sells the acre for $1800. Under current law, taxable gain to the heir is $300 ($1800 minus $1500). Under the tax increase proposal in which the original cost basis is "carried over" to calculate the gain, the taxable gain is $1300, much of which is due to inflation ($1800 minus $500). Disregarding carryover basis, a capital gains tax at death would automatically tax the difference between the decedent's purchase price and its value at death even though the property is not sold. In addition to higher tax bills, these tax increase options present an administrative burden to fiduciaries, cause valuation problems and liquidity problems, and raise the possibility of double taxation through the aggregate effect of estate and capital gains taxes. Moreover, all capital gains are now taxed at ordinary rates which mean even higher taxes.

EXCISE TAXES

Various proposals have been recommended to raise the excise taxes on tobacco and alcohol. Excise taxes on tobacco and alcohol have already been increased in recent years. Higher excise taxes have an adverse trickle down effect on the farmers whose commodities such as tobacco, grains, and wine grapes, go into tobacco and alcohol products. The same argument can be made for farmers whose grain goes into ethanol production and whose market could be damaged if the ethanol exemption is repealed. Higher taxes will lessen the demand for these products and cause reduced marketing opportunities.

GENERAL COMMENTS

We understand that Congressional tax writers are attempting to spread the pain of tax increases by balancing the regressive nature of excise taxes with the progressive nature of estate taxes. However, a major consideration is not understood: Farmers and ranchers are part of an income group caught in the middle and will therefore be hit by all kinds of tax increase proposals. In particular, we urge you to reject increases related to estate taxation and excise taxes.

While we acknowledge the reconciliation requirements of the budget resolution, we ask the Committee to be mindful of the detrimental effects of higher gasoline taxes and an oil import fee; of the damage that could be done to the tax reforms of 1986 by a freeze or increase in income tax rates; of the effects of excise tax hikes on certain sectors of agriculture; and of the problems that the carryover basis, capital gains at death, and a reduction in the unified credit cause for farm families whose family and business assets are affected by these provisions and whose property could have to be sold to pay the taxes.

We recognize the enormous task that the Committee faces and hope that our comments have been useful to you.

Thank you for the opportunity to testify.

Mr. STARK. Thank you, Ms. Rice.
Mr. Powell.

STATEMENT OF JAMES L. POWELL, CHAIRMAN, TAX AND CREDIT COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION

Mr. POWELL. Mr. Chairman and members of the committee, my name is James L. Powell. I am a rancher from Fort McKavett, TX, and chairman of the National Cattlemen's Association Tax and Credit Committee.

As a cattleman and a businessman, I recognize the importance of a fair and equitable Tax Code and the necessity to balance the budget and eliminate deficit spending.

Our association's commitment to deficit reduction is evidenced by involvement in the push for a balanced budget. The 1986 Tax Reform Act was one of the largest tax acts ever passed. Statements were made by various Members of Congress during the consideration of this massive tax overhaul, that there should be no further changes for some time in order to let the provisions of the Tax Reform Act of 1986 work, be understood, and be implemented. To make substantive changes would be unfair and would emphasize the perception of instability in our tax laws.

There is one extremely burdensome provision that needs to be corrected soon to carry forward the theme of the Tax Reform Act of 1986. The new preproductive expensing rule is unfair and unnecessary. We are working with members of this committee to address this problem in a revenue neutral manner.

The NCA feels strongly that the economic situation of this deficit reduction should be addressed by systematic, substantial reductions in Federal spending. If additional revenues must be generated, Congress and the administration should look first toward the improvement of compliance and collection procedures. Then, and only then, should attention be focused on the revenue side. Consideration of a broad-based consumption tax should be the first focus because such a tax does not penalize savings and investment, unlike increased income or State taxes. Also, the type of luxury or excise tax should not in any way apply to property primarily designed for business use.

I would like now to focus on specific areas outlined in the recent publication, entitled "Description of Possible Options to Increase Revenues," prepared by the Committee on Ways and Means.

In 1981, major changes in estate and gift tax laws were made by Congress. These changes have had a very positive and significant impact on allowing family farmers to pass illiquid assets to a family business to generations of farmers and ranchers without tax burden, which would cause the operation to be broken into units that are not economically viable.

To make changes in this area would be improper and cause major restructuring of estate plans by farmers and ranchers. Lawyers would be the beneficiaries. Estate tax rates and unified tax credit should not be altered.

Treating death taxes as a taxable sale of property and requiring appreciated assets to be subject to income tax would be catastrophic to farmers and ranchers.

The carryover basis rules in the revenue proposal are unworkable, as was discovered in 1978.

The cash method of accounting represents more than 90 percent of the farmers being used as their method rather than accrual accounting. With the loss of income averaging in the 1986 Tax Reform Act, cash accounting remains the only viable way for farmers to average out income from year to year.

To restrict the use of cash accounting by bona fide farmers and ranchers, regardless of their income level, is not warranted and would be divisible and create unfair competition.

The 1986 Tax Reform Act and prior acts eliminated farming as a tax shelter, to restrict losses of bona fide farmers and ranchers would make it very difficult to continue agricultural operations where many ranchers and farmers have diversified to supplement their income by part-time employment off the farm.

The phase-in, as promised in 1986 Tax Reform Act, should be allowed to come into effect. Like-kind exchanges should be permitted as under current law, and no changes should be implemented. To tax such exchanges would impose a liquid problem.

A broad-based energy consumption tax would be particularly harmful to agriculture which uses large amount of energy to produce food and fiber.

The cost of implementing a value added tax and its impact on commercial transactions should be carefully examined and considered.

In conclusion, certainly the stability in tax laws are vital so that agricultural producers can make wise economic decisions and plan ahead. The recent tax reform debate promised a fairness, lower tax rates, and a level economic playing field. These are still very much in the minds of those who worked with you in achieving significant and positive tax reform. To abandon those with you, those ideals and goals by making additional changes and not scaling down tax rates would send the wrong signal to those who supported the Tax Reform Act of 1986.

Mr. Chairman, we appreciate the opportunity to express our views, and I will be happy to entertain questions.

Thank you.

[The statement of Mr. Powell follows:]

NATIONAL CATTLEMEN'S ASSOCIATION

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Suite 300
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(202) 347-0228

Testimony on Behalf

of the

NATIONAL CATTLEMEN'S ASSOCIATION

on
Possible Options to Increase Tax Revenues

before

Chairman Dan Rostenkowski and the
Ways and Means Committee

submitted by

James L. Powell, Chairman
NCA Tax and Finance Committee

July 8, 1987

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry--including cattle breeders, producers, and feeders. The NCA represents approximately 200,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 18 affiliated national breed organizations.

Mr. Chairman and members of the Committee my name is James L. Powell. I am a rancher from Ft. McKavett, Texas, and chairman of the National Cattlemen's Association Tax and Credit Committee. Today I am accompanied by Alan C. Sobba, manager of Tax and Credit with NCA. We appreciate the opportunity to testify before this committee today and share our views on options to increase tax revenue. The National Cattlemen's Association represents farmers and ranchers nationwide through direct membership in our association and through various affiliated state associations.

Agriculture and the cattle industry are undergoing some very difficult and changing economic times. My ranch is located in southwestern Texas, and I have been actively involved in farming and ranching all my life. As a cattleman and a businessman, I recognize the importance of a fair and equitable tax code, and the necessity to balance the budget and eliminate deficit spending. Our association has been very active on tax issues for many years, and we appreciate this Committee's invitation to once again testify on very important tax considerations which will affect the cattle industry. Our commitment to deficit reduction is evidenced by involvement in the push for a balanced budget.

Over the last three years, our organization worked closely with members of this committee and its staff to ensure that tax reform was fair, equitable and returned business decision-making back to economics. The 1986 Tax Reform Act was one of the largest tax acts ever passed. Statements were made by various members of Congress during the consideration of this massive tax overhaul that there should be no further changes for some time in order to let the provisions of the Tax Reform Act of 1986 work, be understood, and be implemented. To make substantive changes would be unfair and would emphasize the perception of instability in our tax laws.

There is one extremely burdensome provision that needs to be corrected soon to carry forward the theme of the TRA of 1986. The new preproductive expensing rule is unfair and unnecessary. We are working with members of this committee to address this problem in a revenue-neutral manner.

The NCA feels strongly that the economic situation of deficit reduction should be addressed by systematic, substantial reductions in federal spending. If additional revenues must be generated, Congress and the Administration should look first toward the improvement of compliance and collection procedures. Then, and only then, should attention be focused on the revenue side. Consideration of a broad-based consumption tax should be the first focus because such a tax does not penalize savings and investment, unlike increased income or estate taxes. Also, any type of luxury or excise tax should not in any way apply to property primarily designed for business use.

I would now like to focus on specific areas outlined in the recemt publication entitled Description of Possible Options to Increase Revenues, prepared for the Committee on Ways and Means.

Estate and Gift Tax Laws

In 1981, major changes in estate and gift tax laws were made by Congress. These changes have had a very positive and significant impact on allowing family farmers to pass illiquid assets in a family business to future generations of farmers and ranchers without tax burdens, which would cause the operation to be broken into units that are not economically viable.

To make changes in this area would be improper and cause major restructuring of estate plans by farmers and ranchers. Lawyers would be the beneficiaries. The ability to implement an effective and fair estate plan is dramatically affected by each change in the estate and gift tax laws. Each time the rules of the game are changed, it requires our members to once again review their estate plans to ensure they are in compliance.

Estate tax rates and unified credit should not be altered. The value of farms and ranches obviously fluctuates and appreciates at different rates. However, any changes in this area at this time would have a very disruptive and potentially burdensome effect on the ability of farmers and ranchers to pass on an economically viable operation to the next generation. In addition, many small and mid-sized family operations are undergoing severe economic times, and to impose the burden of additional estate taxes would have a very damaging effect on an already acute cash flow situation.

Treating death as a taxable sale of property and requiring appreciated assets to be subject to income tax would be catastrophic to farmers and ranchers. Death is a very inopportune time to impose a tax on a family which is trying to keep the operation together.

The carryover basis rules in the revenue proposal are unworkable, as was discovered in 1978 when the Carter Administration proposed such legislation. To deny minority discounts overlooks the recognized practice of valuing property interest at fair market value. The extensive record-keeping burden that this would impose on farmers and ranchers would be extremely difficult to comply with, and would be unfair. These records would be difficult--if not impossible--to locate in the decedent's estate and be maintained by the heirs.

Cash Method of Accounting

More than 90 percent of all farmers and ranchers use the cash method of accounting. With the loss of income averaging in the 1986 Tax Reform Act,

cash accounting remains the only viable way for farmers to average out income from year to year. The cattle business is a very volatile business, with factors such as price, weather and an entire host of other economic considerations causing income to fluctuate greatly from year to year.

The 1986 TRA and previous tax acts clamp down on the use of cash accounting by farming syndicates and others not engaged in farming or ranching on a bona fide basis. To restrict the use of cash accounting by bona fide farmers and ranchers, regardless of their income level is not warranted and would be divisive and create unfair competition. Arbitrary restrictions or caps that are placed on the use of cash accounting are unfair, restrictive and disregard economic considerations.

Restrictions on Farm Losses

The proposal to limit the deductibility of all farm losses and treat those as passive losses, similar to real estate, ignores the major differences between farming and real estate. Farming and ranching is a very capital intensive business requiring high-leverage positions and utilization of all types of capital. Loss limitations for those actively involved in farming and ranching ignores the fundamental economic realities of agriculture and builds a wall around our industry that is economically unhealthy.

The 1986 TRA and prior acts eliminated farming as a tax shelter. To restrict losses of bona fide farmers and ranchers would make it very difficult to continue agriculture operations where many farmers and ranchers have diversified to supplement their income by part-time employment off the farm. NCA supported efforts by this committee and Congress to curtail abuses of tax laws. We encourage you to recognize the damaging effect that a restriction of the deductibility of farm losses would have on agriculture.

Income Tax Rates

The 1986 Tax Reform Act established tax rates, exemptions and deduction amounts which should not be changed. The phase-in, as promised in the 1986 TRA, should be allowed to come into effect. There should be no reduction in deductions allowed by this Act, such as soil and water conservation expenditures. Like-kind exchanges should be permitted as under current law and no changes should be implemented. Such exchanges are frequently used by farmers and ranchers for business and economic reasons. To tax such exchanges would impose a liquidity problem.

Furthermore, no limitations should be applied to installment sales contracts, since such sales were significantly curtailed and restricted in the 1986 TRA. In addition, a corporation using the LIFO method of valuing inventories should be permitted to elect "S" corporation status without being required to include in income the LIFO recapture amount. The current

provision on excluding income for meals and lodging provided to employees on an employer's premises should be continued.

Energy Consumption Tax

A broad-based energy consumption tax would be particularly harmful to agriculture which uses large amounts of energy in producing food and fiber. This type of tax would almost certainly increase the cost of production and ultimately the cost of food. At some point, this type of tax would be passed on to the consuming public. Farmers and ranchers are at the beginning of the food chain and such taxes would impose another cost to the producer at a time when many are struggling to stay in business.

Value Added Tax (VAT)

The cost of implementing a VAT and its impact on commercial transactions should be carefully examined and considered. The 1984 Treasury Report should be updated. Although a tax would likely raise significant revenues, the time and cost of administration and the widespread impact it would have should be carefully evaulated. In no case, should necessities such as food be included in such a tax.

Taxing Trade Associations

Trade associations use income from investments to carry out their exempt purposes and such income should not be taxed. This income is a vital source of funds to trade associations. The unrelated business income tax imposed on social clubs cannot be likened or equated to trade associations. This analogy is incorrect and fails to recognize the very important role and economic purpose that trade associations play to businessmen such as farmers and ranchers.

Conclusion

We recognize that this Committee has a very difficult task of determining how to meet budgetary goals and achieve effective deficit reduction. As we stated earlier, primary attention must focus on reduced spending, and taxation should be resorted to only if all other methods and avenues have been exhausted.

Certainty and stability in tax laws are vital so that agricultural producers can make wise economic decisions and plan ahead. The recent tax reform debate, promised fairness, lower tax rates and a level economic playing field. These are still very much in the minds of those who worked with you in achieving significant and positive tax reform. To abandon those ideals and goals by making additional changes and not scaling down tax rates which would send the wrong signal to those who supported tax reform in 1986.

Chairman Rostenkowski and members of the committee, we appreciate this opportunity to express our views. NCA will continue to be an active organization on tax law changes, and we look forward to working with the members of this committee and their staffs. I would be happy to entertain your questions.

Thank you.

Mr. STARK. Mr. Hassebrook.

STATEMENT OF CHUCK HASSEBROOK, TAX POLICY ANALYST, CENTER FOR RURAL AFFAIRS

Mr. HASSEBROOK. Mr. Chairman, members of the committee, thank you for the opportunity to testify.

I will speak in support of four provisions, including a prohibition on use of cash accounting by large corporate farms, extension of the depreciation term on single-purpose agricultural structures, on application of the rental real estate rules to farm losses with some revision, and increased taxation on very large estates.

It may strike you as unusual that an agricultural group would speak in support of provisions that will increase the tax level on agriculture, but I do so because these changes, I think, strike at the heart of some of the deepest contradictions in U.S. farm policy, contradictions that are really unfair to both the taxpayer and the farmer.

Last year, the Government spent about $30 billion to control farm production, support farm income, and try to keep family farmers in business, and at the same time, the Government was losing billions of dollars of revenue to tax shelters for corporate farming, that subsidized an expansion of production by corporate farms and granted them a competitive advantage with which to displace family farms, with the net result that the Government is asked to spend more money to counter the effects.

And I think that the issue that has been raised about cash accounting may be the best illustration of these contradictions in U.S. farm policy. Let me give you an example.

Last year, the Government was operating a thing called the dairy herd buyout program, where, in order to reduce the surplus of milk products, the Government was paying farmers to slaughter their milk cows. I think it was generally in the range of about $250 a cow. I am not sure of the exact amount.

But at the same time, through use of cash accounting, a tax-wise corporation could gain tax savings of as much as $400 per cow to increase the size of a herd. It was kind of like a dairy herd buyout in reverse. I do not think that makes any sense.

And not only does that provision add to surpluses of all farm products, including dairy products, but I think it also changes the rules of competition in agriculture, because it disproportionately benefits the high-bracket large corporate farm and thereby puts the average family farmer at what I think is an unfair competitive disadvantage.

I used the example of the $400 tax savings for adding a cow to the herd for a top-bracket corporation. For the average farmer, in the 15-percent bracket, that benefit would be less than half. And it seems to me, that unless we want to add to the milk surplus, unless we consciously want to displace family farmers with corporate farms, this is not very good public policy and it is not a very good use of scarce Federal dollars.

I think many of the same criticisms can be made of another provision which defines a single-purpose agricultural structure as a piece of equipment.

Now a single-purpose agricultural structure is essentially a building for hogs, chickens, or dairy. In the Tax Code, though, we do not call these buildings buildings, we call them equipment.

And the reason is, by calling them equipment they are eligible for 7-year 200 percent declining balance depreciation. I have some photos here of some single-purpose agricultural structures that I would offer. I do not have enough for everyone but we could pass one around. It is only to establish that these are in fact buildings, in spite of what the Tax Code says. I might also add that in my written testimony, and included in the appendices, are some statements from economists at land-grant universities and some extension poultry and hog specialists, testifying to the long useful lives of these facilities.

Let me give you an example of how that could end up actually hurting a family farmer, even though it might seem to offer him a tax benefit. Right now, in South Dakota, a corporation called National Farms is looking around for a place to build a 300,000 head hog operation.

Now National Farms is owned by the Bass Bros. out of Fort Worth, TX, which is one of the wealthiest families in the country. So it is undoubtedly a family farm because it is family-owned.

The combination of these two provisions, that is, calling their buildings equipment and calling this huge corporate farm a family farm, will yield tax subsidies of about $4.5 million to build that operation.

Now the hogs they produce up there are sufficient to displace about 300 family farmers and to lower hog prices by over 30 cents a hundredweight. I ask you if that makes any sense when, at the same time, the Government is putting money, for example, into the Farmer's Home Administration to try to get family farmers started on the land and to try to help them survive. At the same time we create this kind of a subsidy to help a very large corporate farm displace family farms.

One last issue I would like to touch on is the area of gift and estate taxation. I think we sometimes forget, that gift and estate taxes were created in order to foster, small business, small farms, and small property owners.

To think back to the beginning of this Nation, there was a concern with what had been left behind in Europe, essentially a landed gentry owning most of the property in the country. The idea of estate taxation was that we needed to counter that tendency toward very concentrated land ownership if we wanted to maintain small business and small farms.

I think the estate-tax system in this country has ceased to be an effective counter to excessive concentration of wealth. I have appended to my written testimony an example of how a farm family could use the current gift and estate tax rules to pass on $6 million worth of farm land without paying a penny of gift or estate taxation.

The heirs of that $6 million of farm land income could simply take the unearned income that they gain by renting that land out, and buy an additional $570,000 worth of land every year.

Now I do not think that is really fair competition for a farmer trying to buy land with what he earns by farming it from the

sweat of his brow, and, for that reason, I think we need to look at some ways of making that tax more effective.

One option, I would suggest to you, would be to say that through no combination of all of the existing rules, through no combination of the estate-tax credit, special-use valuation, tenancy-in-common, and tax-free gifts—through no combination of those should any family be allowed to exempt more than $1 million worth of property from gift and estate taxation.

That way, we would protect the small business and the small farm, but we would get at some of these very large estates. Thank you.

[The statement of Mr. Hassebrook follows:]

Statement of Chuck Hassebrook

on Behalf of the Center for Rural Affairs

Before the House Committee on Ways and Means

on the Budget Reconciliation Tax Bill

July 1987

Thank you for the opportunity to testify. I come before you to speak in support of four of the revenue raising options being considered by the committee including denial of cash accounting to large corporate farms, a longer depreciation term for single purpose agricultural structures, increased taxation on large estates and stricter limits on deduction of farm losses.

These proposals strike at the heart of some of the deepest contradictions in U.S. farm policy; contradictions unfair to both the American taxpayer and the family farmer. While the federal government spent $30 billion last year on farm credit and commodity programs to support farm income, reduce surpluses and help family farmers survive; it was also losing billions of dollars of revenue to corporate farm tax shelters which work in direct contradiction to the stated goals of U.S. farm policy. By granting a disproportionate benefit to high bracket corporate farms, these provisions place low and moderate income family farmers at a competitive disadvantage. They act as magnets for investment in agriculture, with the result that more is produced, lower prices are paid to farmers for their products and Congress is asked to spend more on farm programs to counter the effects.

Corporate Cash Accounting

The provision that best illustrates these contradictions is the special exclusion for so called "family farms" from the rule denying use of cash accounting to corporations with sales of more than $5 million. Cash accounting grants a powerful competitive advantage to high bracket taxpayers and offers irresistible subsidies to expand production. Any income reinvested in expanding inventories, breeding herds or flocks is fully sheltered from taxation as long as the operation stays at that size or continues to grow. For example, while the federal government paid farmers to slaughter their milk cows through the dairy herd buy out program last year, tax wise corporations used cash accounting to reap tax savings of as much as $400 for each cow added to the herd; like a dairy buy out in reverse. The benefit would be less than half that amount for a family sized farmer in the 15 percent bracket. Unless we want to produce more milk and replace family farms with corporate farms, this is bad public policy and a waste of scarce federal dollars.

The companies which would be weaned of cash accounting by this proposal are fully capable of using accrual accounting. These are not small family farmers. They are large agribusinesses with their own accounting departments. They want cash accounting not for its simplicity, but for a tax shelter. For example, Tyson Foods Inc., one of these so called family farms, received a net tax refund of $1 million on profits of $69 million and annual sales approaching $1.5 billion, from 1981 through 1984. Hudson Foods, with sales of $185 million deferred $7.6 million of taxation in 1985, "playing the loophole with the skill of Stephane Grapelli on jazz violin", according to Forbes Magazine (attached). I am reminded of Justice Stewart's statement in a 1964 pornography ruling, to the effect that he knew pornography when he saw it, and the movie in question was not that. I know a family farm when I see one, and these are not family farms. I urge the committee to treat farm corporations like other corporations and deny them the use of cash accounting if their sales exceed $5 million.

Single Purpose Agricultural Structures

Single purpose agricultural structures are livestock, dairy and poultry buildings. They are defined as equipment in the tax code, to make them eligible for seven year 200 percent depreciation. The original argument for

placing these buildings in the equipment category was that they are an integral part of the equipment they house and therefore their lives end with the equipment. The fact is, however, that the equipment is clearly separable from the structure and routinely replaced. The structure in almost every case has a longer life than the equipment. Attached are copies of letters from Iowa State University Extension Livestock Specialist Earl Mobley and Robert Fritschen, Director of the University of Nebraska Panhandle Extension Station testifying to that point regarding hog production facilities. As regards poultry facilities, land grant universities generally assume a 20 year life for facilities. University of Arkansas Agricultural Economist W. A. Holbrook said in a November 12, 1985 phone conversation that poultry buildings have lives of from 15 to 20 years. He expects their lives to increase as the industry matures and technological obsolescence becomes less of a factor. University of Georgia Extension Poultry Specialist Paul Aho indicated in a July 2, 1987 telephone conversation that poultry equipment has a life of approximately 15 years and poultry structures of approximately 30 years.

Like cash accounting, this inconsistency in the tax code has attracted excess investment to agriculture and changed the rules of competition by granting a competitive advantage to large, high bracket and capital intensive corporate farming operations. For example, Metropolitan Life Insurance Company, in conjunction with Tyson Foods, recently invested $14 million in 200 poultry houses to take advantage of the special tax treatment of these facilities. The facilities are leased to farmers who will use them to raise broilers owned by Tyson Foods, on contract. While this is advantageous to Metropolitan Life, it may not be so beneficial to most broiler growers. The mass introduction of tax subsidized poultry facilities reduces demand for the services and facilities of existing growers. As a result, they will be paid less for them than would otherwise be the case. To make matters worse, the fast write off is worth nothing to many growers. Dr. Holbrook says that most Arkansas growers don't have enough income to use the entire depreciation writeoff on a building in a few years.

The impact is much the same in the hog industry. We used present value analysis to compare the value of speeding up depreciation on these structures to three hog producers; a small beginning farmer with a modest income and low cost facilities; a larger and better established family operation with new facilities and more income; and a large corporate hog operation. The break is worth nothing to the beginning farmer because he has insufficient income to make full use of his depreciation deduction over seven years. To the more established farmer, the break is worth $26.18 per sow in the herd and for the large corporate farm the break is worth $98.91 per sow in the herd. Unless we desire to replace family farms with corporate farms and to block entry into agriculture by young beginning farmers, this is bad public policy and a waste of scarce federal resources. It should be noted that the Farmers Home Administration is spending millions of dollars on programs to help young people enter agriculture, I think justifiably. What is not justified are tax policies which put people with limited financial resources at a competitive disadvantage. I urge that you adopt the proposal to place single purpose agricultural structures in the 15 year depreciation category.

Combined Effect

Together, cash accounting and the special treatment of single purpose structures have a profound effect on the meat and milk sectors. They create barriers to entry, lower profitability, increase the cost of government farm programs and shift control out of the hands of family farmers into corporate hands. One immediate example is the announcement by National Farms, Inc. of plans to build a 300,000 head hog operation in South Dakota. National Farms is undoubtedly a family farmer under current tax policy, because it is family owned by the Bass Brothers of Forth Worth Texas, one of the nation's wealthiest families. Cash accounting could subsidize that expansion by as much as $3 million and the special treatment of single purpose structures by approximately $1.5 million. The additional production is sufficient to displace 300 family sized farms. The additional hogs will reduce by 23¢ to 35¢ per hundred pounds the price paid to family farmers for their hogs across the entire nation.

Death and Estate Taxes

It has been forgotten in recent years that estate taxes were created to foster the broad distribution of property ownership by preventing excessive concentration of wealth. Progressive and effective estate taxation would strengthen family farming. We do not have an effective estate tax today. Well planned gifting and estate programs which make effective use of tax exempt gifts, tenancy in common, special use valuation and the estate tax credit allow families to pass on land approaching $10 million in value, tax free. This is not a policy to save the family farm, but rather the landed gentry. This policy creates stiff competition for family farmers seeking to buy land with the income they earn by farming it. For example, the heirs of a $6 million tax free inheritance could use the unearned rental income from that land to purchase an additional $570,000 of land each year (see the attached analysis). Farmers who must purchase land with what they earn by the sweat of their brow cannot compete with that kind of inherited wealth unfettered by estate taxation, regardless of how efficient and productive they may be. I would suggest that the committee examine a $1 million limit on the amount of wealth which can be excluded from taxation by one family through any combination of these provisions.

As regards taxation of capital gains of estates, I would favor a tax on gains at death rather than reinstatement of the carryover basis. After several generations of accumulated gains, the latter could become a strong disincentive for sale of land and other property. Much farm land would remain in the hands of families long removed from agriculture, rather than being sold to the people who work on it. If a tax on capital gains at death is enacted, I would favor exclusion of the gain on a modest amount of property.

Application of the Rental Real Estate Rules to Farm Losses

I support this proposal, but offer a compromise which addresses the concern that it might discourage needed investment and force sale of land to avoid nondeductable losses. I would apply the rental real estate rules only to farm investments involving cash basis accounting. Accrual basis taxpayers would be unaffected. No profit motivated investment would be discouraged and no one would be forced to sell assets. Yet, many tax motivated investments would be eliminated and competition would be fairer. No longer would tax motivated investors enjoy the advantage over farmers of being able to make money through tax savings without showing an economic profit.

Cooperative Extension Service
Institute of Agriculture and Natural Resources
University of Nebraska–Lincoln

Panhandle Station
4502 Ave. I
Scottsbluff, NE 69361
308-632-1230

June 5, 1984

TO: Chuck Hassebrock
Center for Rural Affairs
Walthill, NE 68067

RE: Buildings versus Equipment

There is a distinct difference between buildings and equipment as related to swine facilities, or nearly any other structure involved in agriculture.

Specifically in swine production, the building is simply a physical boundry referred to as a structure, that allows us to arrange the equipment in such a way to enhance production. A building is the frame that surrounds the equipment.

In this case the equipment would be farrowing crates, pens, feeders, or pen dividers.

The building may be used for other than the original purposes, but the equipment is useful, almost exclusively, only for the original designed purpose.

Again, in the case of swine facilities, much of the equipment is worn out in five to eight years, while the building that houses the equipment, with on-going maintenance, lasts for more than twice this period.

Sincerely,

Robert D. Fritschen

Robert D. Fritschen
Director

RDF:bj

Iowa State University of Science and Technology
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Telephone: 712 258-0651

RECEIVED

June 4, 1984

Bruce Davies
House, Ways and Means Committee
1136 Longworth HOB
Washington, D.C. 20515

Dear Mr. Davies:

I recently had a conversation with Mr. Chuck Hassebrook in regard to tax laws for agriculture. Specifically we addressed the issue of single purpose buildings and their related tax depreciation schedules. He asked me if I would review with you what most of my pork producers who are on an enterprise record program do with their depreciation schedules.

Normally the people I work with use ten year depreciation schedules for their swine buildings. In most instances, the equipment on the interior of the building is on a five to seven year schedule. We don't expect the panels separating pens, feeders and other equipment to last much longer than five to seven years. The building would normally be expected to last for fifteen to twenty years.

In my opinion, the new tax laws allowing a five year depreciation write off definitely favors non-agricultural capital investment. I personally believe the tax depreciation laws should be realistic and somewhat close to the normal expected lifetime of a given building or equipment.

Hope this information may be of some value to you. If I can be of any more service, please feel free to contact me.

Respectfully yours,

Earl Mobley

Earl D. Mobley
Extension Livestock Production Specialist

EDM/cs

cc: Chuck Hassebrook

. . . AND JUSTICE FOR ALL
Programs and activities of Cooperative Extension Service are available to all potential clientele without regard to race, color, sex or national origin. Anyone who feels discriminated against should send a complaint within 180 days to the Secretary of Agriculture, Washington D.C. 20250

Iowa State University and U. S. Department of Agriculture cooperating

CENTER FOR RURAL AFFAIRS
Wallhill, Nebraska 68067
Population 900

TAX BREAK ON LIVESTOCK AND POULTRY BUILDINGS HURTS FAMILY FARMERS

When the House and Senate each completed their versions of the tax reform bill in 1985 and 1986, they both agreed that one widely abused tax shelter should end. Livestock, dairy and poultry buildings had been defined as equipment for tax purpose to qualify them for an unrealistically short depreciation term. The irrational provision encouraged more expansion in an industry already burdened by overproduction and placed family farmers at an unfair competitive disadvantage with large corporate farmers who could better exploit the break. Nonetheless, when the conference committee revealed its version the corporate farmers had won. The tax shelter survived.

The following example compares the benefit of this break to three different hog producers: a 15% bracket beginning farmer with 40 sows and $15,000 invested in remodling old barns; a 15% bracket, 100 sow established farmer with $60,000 and some of his own labor invested in new farrowing, finishing and nursery buildings; and a 34% bracket 10,000 sow corporate operation with $10 million invested in new buildings*. We measure the value of the break by comparing the present value of the tax savings under the seven year equipment depreciation schedule with the present value of the tax savings under the 15 year depreciation schedule, which is more reflective of the buildings' useful lives.** This the interest value of having the savings sooner under a faster writeoff. The break is worth nothing to the beginning farm couple, making $18,000 per year. Accelerating the depreciation creates more writeoffs than they have taxable income, causing them to forfeit part of the standard deduction and personal exemptions for their family of five. The established family farmer gets only one fourth the break as the large corporate farm. The break is worth more the higher the tax bracket and the more invested in facilities (capital) to replace labor.

VALUE OF ACCELERATING DEPRECIATION ON HOG BUILDINGS

	Beginning Farmer 15% Bracket	Established Farmer 15% Bracket	Corporate Farm 34% Bracket
Benefit Per Sow In Herd	00.00	$26.18	$98.91
Hog Price Increase Of Equal Value To The Break***	00.00	$.08	$.31

The Long Term Cost - Because this break encourages more building and production, it lowers hog prices. The established farmer's $.08 per 100 lbs. tax benefit will be more than lost by the price impact of just 100,000 additional corporate hogs. The 7,000 sow expansion by Murphy Farms, Inc. (of North Carolina) in 1986 will cost more in lower hog prices than the average farmer gains from rapid depreciation of hog buildings.

*Building costs include structures only; not equipment.
**We use a 10 percent discount rate.
*** Per 100 lbs produced over 15 years, discounted to present value at 10%

ESTATE TAX LOOPHOLES PAVE THE WAY TOWARD A LANDED GENTRY

The estate tax could contribute to the survival of family farm agriculture by discouraging the concentration of land in a few wealthy hands. Wealth begets more wealth in a capitalist economy. Without measures such as estate taxes to offset the resulting concentration, wealthy people can pyramid ever greater amounts of wealth upon their initial advantage, until economic control rests in a few hands and opportunity is lost to all but those born to wealth.

Unfortunately, current estate and gift tax laws are so full of loopholes as to be largely ineffective. In the following example, a wealthy couple passes on 10,000 acres of land tax free, worth $6 million. After retirement, the parents make tax free gifts of $20,000 worth of land each year to each of their 12 heirs (four children and eight grandchildren). After fifteen years they have distributed $3,600,000 worth of land. When they die, the remaining $2,400,000 worth of land will be reduced to $1.2 for estate tax purposes through the use of special use valuation. The remaining $1.2 million will be entirely free from taxation under the estate tax credit, which exempts $600,000 per person.

Through their $6 million inheritance, the heirs gain an advantage over smaller farmers and use that advantage to buy an additional 950 acres each year. They form four family corporations and farm the land. After expenses and paying salaries to family members, the corporations receive a six percent return on the $6 million of inherited land, for a total of $360,000 per year; $284,600 after income taxes. This is the "unearned" portion of their income. It is what they could earn by cash renting the inherited land to other farmers. The unearned income is sufficient to make a 50 percent down payment on 950 acres of $600 per acre land each year. With the down payment and a 10 percent interest rate insurance company loan, the land cash flows.

Can efficient smaller farmers who must buy land with income they earn by farming, rather than returns on large inheritances, compete with this family for land? Is this fair competition? Will opportunity to own land be limited to high income investors and people born into wealthy families?

Six Million Dollars Worth of Land Inherited Tax Free

Tax Free Gifts	$3,600,000
Reduction of the Estate Through Special Use Valuation	$1,200,000
Estate Tax Credit ($600,000 Each for the Mother and Father)	$1,200,000
Total Tax Free Inheritance	$6,000,000

CORPORATE CASH ACCOUNTING MEANS CORPORATE FARM EXPANSION

When is a corporation with sales of over $1 billion a family farm? The answer: when corporate farmers and high paid lobbyists go to work on Congress.

Congress warped the definition of family farm to allow corporate giants such as Tyson Foods, Inc., with annual sales of over $1 billion, and Perdue Farms, with sales of over $700 million, to use cash accounting. This tax break is generally denied to corporations with over $5 million sales, except for "family farms". Most corporations are required to use accrual accounting, which means that increases in inventory are counted when computing income for tax purposes. Under cash accounting growth in inventory is ignored. This creates lucrative opportunities for tax avoidance and powerful incentives for expansion. Income reinvested in expanding the inventory is deductable, but the increased value of the inventory is not taxed. That means that each dollar invested in expanding the inventory is sheltered from taxation indefinitely.

Corporate cash accounting is is an invitation to corporate farm expansion at the expense of family farmers. In some cases this makes a mockery of federal farm policy. While the government is paying farmers to slaughter their dairy herds, cash accounting provides tax savings of over $400 for each cow added to the corporate dairy herd. This includes the tax savings from adding a $600 raised heifer to the herd, rather than selling her and realizing taxable income; and the deduction for prepaid feed purchased for the heifer in years prior to its consumption. (Prepaid expense deductions are limited to 1/3 of total farm deductions). In the hog industry, cash accounting subsidizes the expansion of the herd by $215 dollars per gilt added to the herd.

SUBSIDIES FOR ADDING ONE DAIRY HEIFER AND ONE GILT TO THE CORPORATE HERD

	Swine	Dairy
A. Value of Raised Heifer/Gilt Not Subject To Taxation	$120	$600
B. Deduction For Prepaid Feed For One Heifer/Gilt Added to Herd	$513	$600
C. Total Reduction in Taxable Income (A plus B)	$633	$1,200
D. Tax Savings Per Heifer/Gilt Added To Herd (Reduction in Taxable Income x 34% Tax Bracket)	$215	$408

Also, cash accounting shelters the value of the calf and pigs produced by the additional heifer/gilt and not sold before year end. This provides an additional $163 (swine) and $75 (dairy) of tax savings. ALSO SEE BACK PAGE

PREPRODUCTIVE PERIOD EXPENSE RULES ARE NEEDED; BUT THEY MUST BE CHANGED

"A bookkeeping nightmare", is the description often given the preproductive period expense rules. These rules require that farmers capitalize the costs of raising breeding and dairy cattle, horses, and orchards, or continue to deduct these costs and use straightline depreciation on all farm assets. To capitalize these costs means they are depreciated over the life of the cow rather than deducted as incurred.

On one hand, the rules will benefit family farmers by eliminating cash accounting tax subsidies to expand cattle herds and orchard acreage. These subsidies encourage over expansion resulting in lower farm income; and they grant a competitive advantage to high bracket taxpayers who can better exploit the tax benefit. Money invested in raising heifers to expand the herd size is totally sheltered from taxation as long as the herd remains at the larger size or continues to grows. If that heifer were sold rather than added to the herd, the farmer would be taxed on her value. In effect, the government pays a 32% bracket taxpayer $192 for each cow added to the size of his diary herd, more than twice the benefit to a 15% bracket farmer.

TAX SAVINGS PER $600 DAIRY HEIFER ADDED TO THE HERD

15% Bracket	28% Bracket	32% Bracket	34% Bracket
$90	$168	$192	$204

On the other hand, the rules should not create a record keeping burden. It would be nearly impossible for a farmer to separate the cost of raising each replacement heifer from conception, from costs of raising bull calves. Farmers should be allowed to use the unit livestock method of accounting, under which they would make a one time calculation to determine the average cost of raising a diary heifer, for example, and depreciate that amount each time one is added to the herd. It appears that the IRS will allow this.

The rules should also not discriminate against diversified farmers. Specifically, farmers who elect to deduct preproductive period costs should be required to use straightline depreciation only on assets used in the particularly enterprise (for example, the beef cow herd) for which the costs are being deducted. The 1986 tax bill requires straightline depreciation on all farm assets. The diversified farmer with 50 cows sacrifices rapid depreciation on a full line of farm equipment; over $400 of depreciation annually on equipment and buildings for each cow in his herd, versus $6.50 for a Nebraska Sandhills rancher.

BUILDINGS AND EQUIPMENT SUBJECT TO SLOW DEPRECIATION, PER COW IN THE HERD

480 Acre Northeast Nebraska Diversified Grain Farmer, 50 Cow Herd	$404.62*
Nebraska Sandhills Ranch	$6.50*

*Based on University of Nebraska 1985 Crop and Livestock Budgets

Forbes
May 5, 1986

Taxing Matters

When is a $1 billion agri-industrial complex a family farm? When it comes time to pay the income taxes.

Fun and games with chicken feed

By Ruth Simon

MOST REASONABLE observers would not call Hudson Foods a family farm. Based in Rogers, Ark., Hudson is now the country's 17th-largest poultry producer. In the fiscal year that ended last Sept. 28, Hudson earned $8.5 million on sales of $185 million. It went public in February, raising $21.3 million.

Your basic family farm? The Internal Revenue Service, not always a reasonable observer, thinks so. As a result, Hudson was able to defer $7.6 million, its entire federal tax bill, last year under long-standing IRS rules. This deferral can be rolled over more or less indefinitely.

Hudson is not a fluke. Other agri-industrial complexes, including $1.1 billion (sales) Tyson Foods and privately held Perdue Farms (estimated sales, $740 million), also routinely receive tax breaks originally intended for family farms. How? By qualifying under some rather arcane rules that allow "family farms" to use cash accounting instead of the accrual accounting the IRS requires most companies to use when computing taxable income. The rules date from 1919, when the Treasury concluded farmers weren't sophisticated enough to use accrual accounting and said they could use cash accounting instead. Big farmers didn't abuse the provision, because taxes were low. Besides, there weren't many big farms.

The choice of cash or accrual is especially important for livestock farmers because such production costs as feed are incurred well before the livestock is sold.

Consider a chicken farmer. Accrual accounting would require him to report a portion of his feed inventories at the end of each year, while not permitting him to expense the feed until the bird was actually sold. The theory is that the feed is an integral part of the cost of producing the bird. Accrual accounting says income and expenses should be matched, so feed costs should not be deducted until revenue is received.

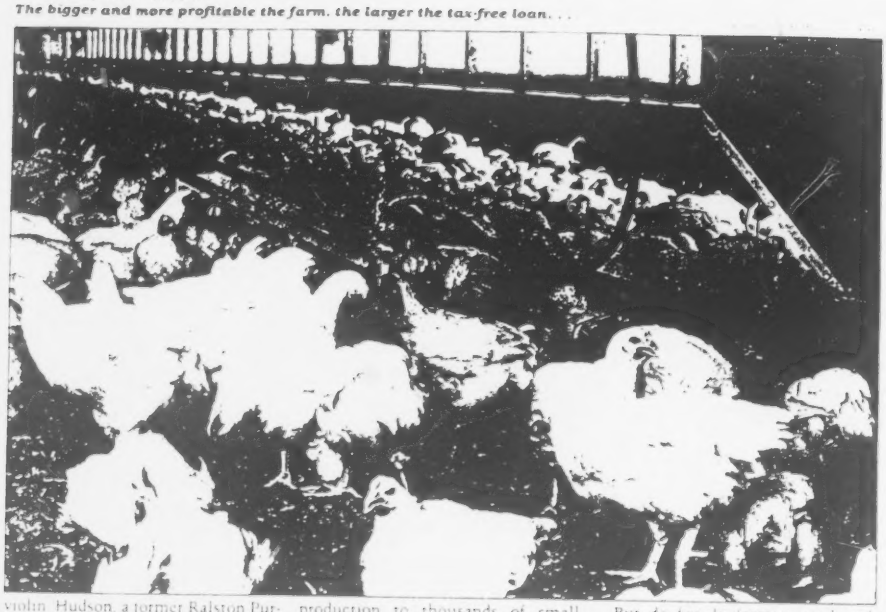
Cash accounting, in contrast, allows the farmer to report cash expenses and receipts when they actually occur. That means the farmer can immediately deduct the feed as an expense, but he doesn't have to report the chickens as income until they are sold. Expensing in the current period while deferring income to a later period amounts to a tax-free loan to the farmer from the Treasury. The bigger and more profitable the farm, the larger that tax-free loan tends to be.

In 1976 the Treasury argued that agribusinessmen were equipped for the rigors of accrual accounting. Treasury tried to limit cash accounting to farmers grossing less than $1 million annually. That sent the big livestock producers squawking to their congressmen, who chickened out. Even a farm grossing $1 billion or more could be a "family farm," Congress said, if at least 50% of its stock was controlled by a single family. It also carved out exceptions for individuals, partnerships and Subchapter S corporations and for farm corporations controlled by two or three families.

Hudson Foods Chairman James Hudson played those loopholes with the skill of Stephane Grapelli on jazz

Chicken Inspector Slaughter

The bigger and more profitable the farm, the larger the tax-free loan. . .



violin. Hudson, a former Ralston Purina executive, and two other investors bought the business from Ralston Purina in 1972. Hudson bought out his co-investors in 1984, and took the farm public in February.

But note the key. Hudson Foods has 12 million shares outstanding. James Hudson owns outright 7 million of those shares, 58%, and has the right under a revocable proxy to vote an additional 3 million shares owned by his family and company executives. With Hudson effectively controlling 10 million shares—83% of the common—Hudson Farms can do several more public offerings and still qualify as a "family farm."

Hudson cheerfully agrees. It's been a long, long time since he drove a tractor. But he says: "Farming, as defined in the tax code, is the production of farm products. It doesn't matter whether you ride a tractor or a horse." In other words, says Hudson, all farmers are created equal and should be treated equally by the IRS.

Springdale, Ark.-based Tyson Foods, the nation's second-largest poultry producer (after ConAgra), is also proving adept at playing by the family farm rules. This $1.1 billion agricompany contracts out chicken production to thousands of small farmers, and it derives more than 60% of its revenues from such "further processed products" as Chicken McNuggets and frozen dinners.

To remain a family farm—but also raise public equity—Tyson recently reincorporated in Delaware, where it can issue two classes of stock. The Tyson family will trade its 55% Class A holding for restricted Class B shares that carry ten votes each. Outside shareholders can keep the Class A shares or swap them for Class B, which pays a lower dividend. If only the Tysons make the switch, they will control 92% of the voting rights—far above the magic 50% minimum. Any new stock issued by Tyson will be of the Class A variety.

Important? It is to Tyson. Tyson earned $35 million in the fiscal year that ended Sept. 28. Cash accounting allowed it to defer about $26 million in taxes. That amounted to 78% of Tyson's 1985 federal tax bill.

We consider ourselves as an umbrella over about 6,000 farms and farm families," says Chairman Don Tyson, defending his use of the family farming rules. "If we didn't have this kind of situation, we couldn't protect those 6,000 farmers."

But do family farmers need such protection? The fact is, cash accounting often works against farmers by making cattle, hogs and certain orchards attractive tax shelters and by encouraging overproduction. "I've seen too many instances where egg producers or others on a cash basis will expand their operation to avoid paying income tax," says Agriculture Secretary Richard Lyng, who was briefly on Hudson Foods' board. "That kind of tax policy has caused family farmers a lot of trouble."

Chuck Hassebrook of the Center for Rural Affairs in Walthill, Neb. agrees. "Cash accounting," he warns, "really distorts supply and demand." And Tyson may soon freeze the amount it defers because tax factors are warping its business decisions.

This seems like just the kind of loophole genuine tax reform should plug. Indeed, the Administration's reform proposals would have limited cash accounting for companies with less than $5 million in gross receipts. But the big farmers and their lobbyists squawked as in 1976, and congressmen again clucked. Reforming farmers' cash accounting was one of the first proposals to be dropped last year by congressional tax writers. ■

Mr. STARK. Thank you, Mr. Hassebrook. Mr. Haefner.

STATEMENT OF GEORGE HAEFNER, PRESIDENT, CONAGRA POULTRY CO., ACCOMPANIED BY ELBERT L. THOMAS, JR., VICE PRESIDENT, THE FEDERAL CO.

Mr. HAEFNER. Thank you, Mr. Chairman. My name is George Haefner. I am president of ConAgra Poultry Co. Joining me today, and available to answer any questions that you may have is Mr. Eb Thomas, vice president of the Federal Co.

We are here to express our support for proposal 7(a) on page 154 of the hearing pamphlet, which would raise hundreds of millions of dollars by requiring a few large food processors that currently use the cash method of accounting to use the accrual method. Under the cash method, these food processors deduct expenses in advance of the time of the income attributable to the expenses is earned or received. This difference in the timing of income and expense enables these companies to save hundreds of millions of dollars a year in taxes.

Under a provision added to the code by the 1976 Reform Act, farming corporations are required to use the accrual method if their annual revenues exceed $1 million. An exception to this rule is provided for family farms that generally are too small and too remote to have access to the sophisticated assistance required to use the accrual method. The large food processors that would be affected by the proposals being considered today are currently being treated as family farms under this exception. They are the only large corporations in any industry that are still permitted to use the cash method.

Two brief excerpts from the House Report to the 1976 Reform Act provide insight into the origin of the family farm exception:

> The opportunity for farmers generally to use the cash method of accounting was granted over 50 years ago by administrative rulings. These rulings were issued at a time when most agricultural operations were small operations carried on by individuals.
>
> The primary justification for the cash method of accounting for farm operations was its relative simplicity.

Two paragraphs later, after noting that in recent years many corporations had entered farming, the House report stated:

> It is appropriate to require corporations engaged in farming to use an accrual method of accounting.
>
> Your committee, however, has excepted from this requirement small family corporations in order to continue the cash basis method, essentially for all but the larger corporations engaged in farming.

The intent of the Congress was clear, we believe, reasonable, requiring accrual accounting for farm corporations that, based on their size, could be expected to have the sophistication and resources required to use accrual accounting.

The problem arises with the definition of the term family farm corporation. The term is defined solely by reference to the ownership of the entity, and without regard to its size. Under this definition, very large food processors, including publicly traded corporations with hundreds of millions of dollars of revenue each year, are permitted to use the cash method.

Mr. Chairman, under the proposals being considered today, small food processors and farming corporations would be permitted to continue using the cash method. However, the large food processors would be denied the benefit of the family farm classification. For example, one of the proposals which we continue to support would deny these benefits only to food processors with revenues in excess of $100 million. Clearly, no true family farms would be affected.

Mr. Chairman, we urge the committee to act favorably on the proposals being considered today because it is unfair to all of the taxpayers to allow these corporations to use special rules to reduce the amount of tax they must pay on the income they earn.

It is unfair to other food processors like ConAgra, and the Federal Co., that compete with these corporations for capital, for research and development successes, and for market share.

Moreover, there is absolutely no social or economic reason for preventing large food processors to use the cash method. The only argument these corporations make in support of cash accounting is that they need the tax advantages to insulate themselves and certain small farms that contract with them from adverse market conditions.

In other words, they argue that if they are required to pay their fair share, they will have less cash on hand to deal with hard times. The response to this argument is clear.

First, if ConAgra and the Federal Co. can operate in the same environment without these tax benefits, the cash method food processors can also operate without these tax benefits.

Second, any corporation, in any business, could make the same argument. If many did, and if the Congress listened, we would all be in a great deal of trouble. Finally, Mr. Chairman, the cash method food processors do not need the tax benefits afforded by this loophole to protect the small farmer with whom they contract. The method of accounting employed by a billion dollar corporation simply does not have any effect on the persons that it may contract with, or otherwise employ. The growers that contract with ConAgra and the Federal Co. are not affected in any way by the methods of accounting used by our companies. I should also point out that under the proposals being considered by you today, all of these small farmers would themselves be permitted to remain on the cash method.

Last year, the Congress enacted a true tax reform bill. That bill repealed tax subsidy provisions and closed loopholes left and right, including some that benefited large groups of businesses or consumers, or that supported positive social or economic objectives.

In this light, we urge the committee to respond to this issue of fairness and close a loophole that has no social or economic justification, that benefits only a very narrow group of taxpayers and, most importantly, that costs the Federal Government hundreds of millions of dollars every single year. Thank you.

Mr. STARK. Thank you very much. Mr. Gibbons. I am sorry. Mr. Thomas, are you making a separate statement? Am I cutting you off here?

Mr. THOMAS. No, sir. It is a joint statement.

Mr. STARK. That was a joint statement. Thank you. Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman. I would just like to ask one question, and have each of the members of the panel address it. The question is this. In trying to help move the deficit in a downward trend, do you or do you not support some type of revenue as a reasonable component of the solution?

Mr. HASSEBROOK. Yes. I think that would be reasonable because I think there are tax shelters in the Code that were left untouched by the 1986 Tax Reform Act, and I think we could complete that job and contribute to reducing the deficit at the same time.

Mr. ANTHONY. The four proposals that you talked about, would they bring in $19.3 billion in the first year?

Mr. HASSEBROOK. No, they would not.

Mr. ANTHONY. Would you help us find some other examples.

Mr. HASSEBROOK. Sure.

Mr. ANTHONY. Ms. Rice.

Ms. RICE. Mr. Anthony, our members do not support any tax increases.

Mr. ANTHONY. What do they support?

Ms. RICE. We have consistently supported across-the-board spending cuts, so we have approached it from the spending side rather than the revenue side.

Mr. ANTHONY. And when you say across-the-board, that would be some percentage reduction of all spending?

Ms. RICE. It would be similar to Gramm-Rudman-Hollings type cuts.

Mr. ANTHONY. That would mean that you would take veterans' benefits, welfare benefits and Social Security benefits off the table, before you apply those cuts?

Ms. RICE. Under the current Gramm-Rudman-Hollings, yes, there would be those exemptions.

Mr. ANTHONY. And then you would also take it equally from domestic and defense?

Ms. RICE. Yes.

Mr. ANTHONY. So, if a new trigger were put back into Gramm-Rudman, and if the President accepted no new revenues, and if it called for up to $40 billion worth of budget cuts from the Defense Department, your members would go on record supporting that and telling us to vote for it?

Ms. RICE. I think our board would have to take another look at that——

Mr. ANTHONY. Yes. I think they would, too.

Ms. RICE [continuing]. But based on our policy which has been in the policy book for as long as I have been there, they have supported that.

Mr. ANTHONY. Well, to be quite honest with you, Farm Bureau's policies are there to be changed from time to time, and in fact you have changed your policies, haven't you?

Ms. RICE. Our policies are examined every year by our delegates, and they can change.

Mr. ANTHONY. Sure. And obviously, you would take a new look at each new crisis situation that you have.

Ms. RICE. Under our policy, our counties are beginning that process right now.

Mr. ANTHONY. But at the moment, no revenue, all spending, across-the-board?

Ms. RICE. No revenue, all spending. And I would say too, to pursue the line of questioning that you just brought up in terms of taking certain programs off the table, I would go ahead and present the other controversial issue, that our members have also suggested that there be entitlement reform, and they do not support taking things off the table.

But if current Gramm-Rudman is as far as we can go right now, then that is what our members would support.

Mr. ANTHONY. I see. So your membership does not even agree with the President of the United States, when he said in his own budget message to the Congress that he felt like he needed revenues to make his own program work?

Ms. RICE. No. We do not agree with the President.

Mr. ANTHONY. You do not agree with anybody when it comes to revenues, then. All right. Mr. Haefner.

Mr. HAEFNER. Congressman Anthony, I guess my preference would be for expense reduction first in order to get at this issue. Second, on the revenue side, I would prefer that we continue to work on what the tax reforms of 1986 seemed to begin upon, and begin to close some of the loopholes that continued to exist after the Tax Reform Act of 1986, similar to the one that we are talking about here today.

And, you know, our proposal I think will generate approximately a half billion dollars. If we can find forty different loopholes like that, we are a long way to our $20 billion revenue objective as far as——

Mr. ANTHONY. With some farm exemption at some level—and I think I heard you use a million dollars—you are saying the revenue impact would be a half a million?

Mr. HAEFNER. On this proposal we are using a hundred million dollar revenue. It would generate about a half billion dollars, yes.

Mr. ANTHONY. A half a billion.

Mr. HAEFNER. Half a billion.

Mr. ANTHONY. So that would get us to about $18.5.

Mr. HAEFNER. It is a small bit of the way, but it is a bit of the way, yes.

Mr. ANTHONY. And you would work with us to try to find another $18 billion?

Mr. HAEFNER. Definitely would.

Mr. ANTHONY. Mr. Thomas.

Mr. THOMAS. Yes, sir. The same as George mentioned. I am really not in a position to do other than sympathize with your problem on trying to raise the entire $19 billion. We came here today to show you a way to get some of that money. Maybe it is only a half a billion dollars, but it is a step along the way.

Mr. ANTHONY. Well, I guess I framed it not so much in an economic question as much as I did in a political question. I was just curious as to how you felt as Americans, whether or not you were concerned enough about the deficit that you were willing to bite the bullet and ask for some revenues, or whether you are willing to run the risk on higher deficits.

And what I am hearing you say so far is that you are willing to run the risk on higher deficits and that you do not think it will affect your industry nor your employees. I mean, that is the message that I am hearing from you. Is that the message that you mean to leave?

Mr. THOMAS. No, sir. I personally think a revenue increase is a definite alternative for deficit reduction, and I think deficit reduction is very important. But I do not have any other specific revenue measures other than the one we are bringing before you today.

Mr. ANTHONY. Well, Mr. Thomas, under the rules that we are required to operate under, we are either going to raise $19.3 billion in new taxes, or we are going to add it to the deficit because those are the only two places that it can go. The budget has already been passed, and if we are to implement it, we either raise the money or we do not. If we do not, it is added to the deficit.

Mr. HAEFNER. Well, Congressman, if I left the impression that I did not think it was important to reduce the deficit, I want to clear up that. I mean, I think it is quite important that we do all those things necessary to begin and continue to bring that deficit down.

Mr. ANTHONY. Thank you. Mr. Powell.

Mr. POWELL. Mr. Anthony, I would suggest that it would be wise to improve the compliance and collection techniques to raise the money that is necessary there, or can be found there, and then, if necessary, implement a broad-based consumption tax. I would even look at the value-added tax. Goodness knows, Congress could spend a lot of money if they implemented a value-added tax, but they could also reduce the deficits if they so desired, and I think that is vitally necessary in order to keep the interest rates down and to maintain our position in a competitive international economy.

Mr. STARK. The time of the gentleman has expired. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman. I was not able to hear all the testimony of the witnesses, particularly Mr. Powell who comes from my State. But I welcome him to the committee.

As a rancher and a farmer, I notice that your concerns are among other things—that we not alter the estate and gift tax laws, and I assume that is because you think that would be harmful to the average farmer or rancher. Is that basically correct?

Mr. POWELL. Yes, it is, Mr. Pickle. I feel that the estate and gift tax law should be retained as they are. We have changed those a number of times in the past few years, and especially an addition of the capital gains tax to estate and gift tax laws would be devastating to the farmer, to the small——

Mr. PICKLE. Well, we have some difficulty here in that in the 1981 act set a series of reductions in the estate tax rate to come down to 50 percent. However, over the last 3 years, we have frozen the rate reduction and now there is some contention that we probably ought to again freeze it and not let it go to its 50-percent level.

I would think that would be harmful. A lot of people think that the reduction would be just a real windfall for the wealthy people, when in truth it really hurts a great many people who are not the wealthy people, but are the small ranchers and small business people.

It seems to me like the income is only about $500 million on that rate freeze, and I would hope that we would find the revenue some-

where else. But at any rate, I am mindful of your testimony and I appreciate your coming and pointing that out to the committee. I think it is important, and I thank you for your testimony.

Mr. POWELL. Thank you, Mr. Pickle. I think that is very important. Keep in mind that this devastating economy on agriculture would, with—a deescalation, with a reduction of the deescalation rates of estate taxes would impose greater burdens upon agriculture.

Mr. PICKLE. Thank you, Mr. Powell. Thank you, Mr. Chairman.

Mr. STARK. Mr. Duncan.

Mr. DUNCAN. No questions.

Mr. STARK. Mr. Daub.

Mr. DAUB. Thank you, Mr. Chairman. I have 5 minutes and it is a long day with many to go, so when I ask my questions would you please, for the record, try to be brief.

Let me preface my questions by saying that—and I wish my colleague, Mr. Anthony, my good friend, were here—I will not presume to condescend to question the motives of why you are here. I believe you truly do believe about this country's interest rates, and the effect on your hard-working cattlemen, on your hard-working employees who process poultry in Arkansas, on the farmers and the families that we are concerned about who are members of the Farm Bureau and who are Nebraskans.

So I really believe that cutting spending seems to be an answer to all of this that we have forgotten, and that that would not be inflationary and in fact would add a good deal to the productivity of all of the groups that you have come here today to represent.

I think what you seek is a level playing field. If cash accounting, but not income-averaging, is available to some but not all who farm and ranch; if unused investment-tax credits can be carried forward by some and offset against future income, but it is denied for industry and, for example, farming, otherwise; if those who are W2'ed can deduct the full value of their health-care benefit, the premium paid for that health care, but farmers and small business people cannot, that is certainly not a level playing field.

The answer ought to be either everybody gets these advantages or no one gets these advantages. In fact from all of that there would be substantial revenue and/or gap closing, one way or the other. So I submit one of our objectives ought to be, as a committee, simply to close the gap by putting a level playing field out there.

Then we would have the fairness in this Tax Code that we are all seeking. Let me ask the Cattlemen's representative to tell us, please, how many would be affected in your group with gross sales or revenues over $100 million, if that were the cash-accounting cap?

About 7, 8, 10, 12, 15 operations in the country, or would there be more than that? Would you care to guess?

Mr. POWELL. It would certainly be a guess. I have no idea how many—I do not know any cattlemen who make over a hundred million. I am sure there are family organizations that do.

Mr. DAUB. I think we need to know, too, to try to arrive at the correct decision, how many would be affected by any intended change, and I sincerely would appreciate—I am sure the committee

would—if you could let us know, out of your organization, with some further research, and submit for the record the entities or the families, or the numbers of businesses that might be affected by a level, say, a $100 million, $200 million, $500 million, in terms of a cap on that issue. If you would do that and let us know later, that would be appreciated.

Mr. POWELL. I will attempt to.

Mr. DAUB. Would you do that, attempt to? That would be fine.

[The information from Mr. Powell follows:]

NATIONAL CATTLEMEN'S ASSOCIATION,
Washington, DC, February 5, 1988.

Per your request—a $100 million cap on cash accounting would affect 20–30 cattlemen.

If you need any more information or have any more questions, please call me at (202) 347–0228.

Very truly yours,

ALAN SOBBA,
Manager, Tax and Credit.

Mr. DAUB. The Farm Bureau with respect to the estate tax comment, we have frozen, as Mr. Pickle said, at $600,000, if I remember. We had intended, in 1981, to move, as Mr. Hassebrook suggested, to $1 million.

Mr. Hassebrook suggested, though, that rather than use a million on the value of the estate, that we coordinate all of the other advantages that might occur at date of death, and then lock off the advantage at which no tax would be paid at a million. How would you view his suggestion?

Ms. RICE. I think that we would want to take a closer look at it. Today is the first opportunity I have really had to think about that, so we would want to look at it some more.

I think our concern as far as a unified estate and gift tax credit has been that the committee would make an effort to reduce it. I mean, there have been some indications of taking it back to the 1981 level which would not be acceptable to our members.

Mr. DAUB. I consider it a double tax. I consider a million a very carefully assessed appropriate value, but I would be interested in the idea, the unified idea, that maybe more than a million might be the cap, if you take other features in the code into account, and I would appreciate your input on that particular point.

Let me ask Mr. Hassebrook, on single-purpose structures, I have introduced legislation, H.R. 2228—I think you are familiar with it—which does stretch out the number of years for these buildings that are now defined as equipment.

I used the 15-year timeframe. Is that an acceptable, or should it be 12, or should it be longer than 15?

Mr. HASSEBROOK. I believe 15 is acceptable. I would go so far as to say—and I think in the House bill last year it was 13. That was certainly acceptable to me. Even 10 years, 150 declining balance, would probably be acceptable.

Mr. DAUB. Thank you.

Mr. HASSEBROOK. I think it would be a big improvement anyway. Let me put it that way.

Mr. DAUB. Thank you very much. Mr. Haefner, Mr. Thomas, to make this issue of cash accounting a simple one, I have an article

where it says—and this is from Little Rock, AR—companies like Holly Farms and Hudson Foods of Rogers, AR, they pay regular taxes and are not treated the same way as others are.

Now is it not simply a matter of fairness, that you are trying to say to us that companies that process poultry, most of them pay regular corporate taxes, but there are a few that avoid that by the way in which they are organized?

Mr. HAEFNER. Well, Congressman Daub, let me try to answer that. Of the 20-largest broiler companies in this country, 5 of them are on the accrual method of accounting and we pay regular taxes. For instance, ConAgra, in their most recently published fiscal annual report paid a current liability on taxes of 37 percent.

In our current fiscal year ending in May of this current year—and it is not public yet—we estimate that we will pay in excess of 41 percent on current liability taxes for the last fiscal year.

Mr. DAUB. Let me interrupt. I see our time is up, and I want to be mindful of it, if the chairman would indulge me to finish this last point.

I am quoting from an accounting firm, a New York investment accounting firm, in this article which I have submitted for the record. And it said, quote: "The impact on Holly Farms is that for the same revenue, and the same pre-tax income, we are paying more." Would that be a fair statement?

Mr. THOMAS. Yes, sir. That is a fair statement. We averaged over the last 5 years, 46 percent as an effective current tax rate. So we are paying our fair share and we feel companies using the cash basis who are paying little if any taxes at all, should pay theirs.

Mr. HAEFNER. Excuse me, Congressman. If I could add one more point. In the last 4 or 5 years there are many of our competitors that are on cash method that have paid no taxes compared to his 45 percent and our 37 and 41 percent.

Mr. DAUB. Well, I want to thank the panel very much for your testimony. Again I would like to illustrate to my colleagues that here are a group of hard-working people in business and in farming, and small businesses, as well as big businesses, that would like to contribute to our revenue objectives, and have offered us I think some very appropriate ways of doing so, and I want to thank you all for your testimony.

Mr. STARK. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman.

I did not hear all of your testimony but I got a chance to take a quick look, and I just want to say that we learn from what you have to say to us, but I hope you have learned from some of the things you have heard here today from us.

I just finished listening to the President of the United States talk in my home State of Connecticut. He took revenues off the table, as he has right along, saying any bill would be vetoed. He also, today, in a speech in Connecticut, adamantly said that no cuts would be accepted in our defense budget.

So these cuts that Ms. Rice suggests, must all come out of programs such as education and our infrastructure.

I just want to say that when you go back to the rural farmers, tell them it is a hard task up here. It is not just "those people"

wanting to spend "your money". We have got a real problem here and we are going to have to make some very tough decisions.

I am glad to hear what you had to say. For me, from an urban center, it was most informative, and I will think of it when I am making those tough decisions.

Mr. STARK. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Powell, let me tell you that your statement on the preproductive expense issue is accurate in my judgment. I think we have some work to do to try to simplify that. We did make some changes in the 1986 act. I think we need to go back and take a look at that, and I appreciate your statement on that subject.

Mr. Hassebrook, your testimony on the single-purpose structures is right on point, and I think with respect to Mr. Daub's question, your answer about 12 years, perhaps 10 years, maybe even 7 or 8 years, is a more appropriate life for those structures.

In my judgment, the current treatment is counterproductive to family farmers. That is, I think there are some who think because they were able to get a quicker writeoff on these structures, that somehow that is good for family farmers. That has not been good for family farmers at all.

In fact it has persuaded over-production in certain areas, much to the detriment of most family farmers. We are far better off, I think, to depreciate those structures the way they ought to be depreciated, based upon their economic life, and I appreciate your testimony with respect to that.

Now, let me just ask the question that Mrs. Kennelly I think was referring to. Mr. Powell, and Miss Rice, and others have said the real approach is to cut spending.

I wonder whether, with Ronald Reagan in office, that is possible. Do you think it is possible to cut spending? For example, the biggest area of spending is defense. That is the biggest item in the budget.

Do you think it is possible to cut defense, with the President in office, Ms. Rice?

Ms. RICE. Not given his recent stated intentions, I do not. Could I say that our members' policy has always been a rather conservative approach which is to look at the spending side because our members view tax increases as increasing their cost of production and harming their agricultural economy. And that is the reason our policy is as it is. But the spending side is very important to us.

Mr. DORGAN. But the reason I asked the question the way I did is, there seems to be a myth here that is perpetrated by the President and by some others, that the Congress would like to spend more than the President. Yet, this President has the greatest appetite for public spending of anybody in recent history and probably in the history of the country.

He does not want to spend it on milk; he wants to spend it on jet fighter planes. His budgets call for very significant levels of spending. The biggest is defense, and he would not countenance any cut in defense. In fact he insists on an increase.

The second biggest area is Social Security. If Social Security were cut, we would have an absolute responsibility, in my judgment, to also cut the Social Security tax, the dedicated tax that pays for it.

We could not cut Social Security outlays, but keep collecting taxes to pay for Social Security from the paychecks of the workers in order to use it to pay for defense over on the other side. You could not do that.

That is $525 billion, just those two items alone. Add interest on the debt, nearly $150 billion a year, Medicaid and Medicare over $100 billion and you've got little left over in the budget for other purposes.

The statements that we have got to solve this by cutting spending is absurd. It is especially absurd with this guy in the White House who says the biggest item is off-limits. The fact is we are at gridlock. Spending is not going to be cut sufficiently to deal with this deficit problem.

If that is the case—and I think it is—then we have a responsibility to follow the budget mandate and raise some revenues.

Where should we raise the revenues? That is the serious purpose of these hearings. Nobody likes to raise revenues, but I think some of you have suggested some constructive approaches for us to look at, and I appreciate that.

I just wanted to raise the budget and spending question because I think the President has been mocking the process out there the last several weeks, and apparently appears intent on continuing to do that. I think that is unfortunate, but it is a fact of life at the moment and we are going to have to deal with it.

So we go about our business trying to do what we can to try and make some progress in dealing with fiscal policy. Mr. Chairman——

Mr. HAEFNER. Congressman, I would like to try to respond to that, if I might.

Mr. DAUB. Yes.

Mr. HAEFNER. You know, the President is currently saying no cut in defense spending, and he has said that for a number of years in the past as well, but there always seemed to be a compromise, so he is in a fixed position right now.

Whether or not he compromises time will tell, but isn't Congress also responsible, or shouldn't they be responsible, when they pass a bill on catastrophic insurance coverage, to, at the same time, either cut spending somewhere else, to stay within this mandate that they have been given to control spending?

Mr. DAUB. Well, the chairman will be quick to tell you, if I do not, that the bill on catastrophic insurance also carries with it a requirement to pay for it and a mechanism to do so.

This committee did not pass out something that says here's additional spending and let the grandkids find out how to pay for it. They do that down at the White House but it has not been done here.

Mr. HAEFNER. Well, thank you.

Mr. DAUB. One other point, if I might make it——

Mr. STARK. If the gentleman will yield, I will give back some of my time.

Mr. DAUB. I would be happy to yield.

Mr. STARK. I just wanted to, for Mr. Haefner's information, to say this: The catastrophic bill reported not only by this committee, but by the Energy and Commerce Committee, and the one that

Senator Bentsen is working on in the Senate, all require that that is 100 percent paid for by the beneficiaries, by the Medicare beneficiaries themselves, not other working Americans.

And in no way will the Treasury participate in that, so it is, as we say, revenue-neutral. So we are very conscious of that. I just wanted to set the record straight, and I appreciate the gentleman yielding.

Mr. DAUB. Mr. Dorgan, could I have a yield for 30 seconds on that.

Mr. DORGAN. Yes.

Mr. DAUB. Just as another member of the Health Subcommittee with some affection for my chairman, to slightly disagree with the revenue-neutrality because three-fourths of part B comes out of the General Treasury, not from the beneficiary who may voluntarily choose it, and part of the second tax in the premium is going to be mandatory on all over 65 who pay taxes, rather than just those who voluntarily decide to take part B.

So there is at least an argument over whether it is revenue-neutral and I would like to side with the gentleman who just spoke as a witness a moment ago.

Chairman STARK. The gentleman picks a legitimate nit.

Mr. DAUB. Thank you.

Mr. DORGAN. I am sorry I yielded. Generally speaking, this bill requires a mechanism traveling with it to pay for it, and your point is an accurate one. Congress is not without fault. My only response is, we are at gridlock because you cannot deal with the guy down at the White House.

He wants more spending for his areas, no revenue to deal with it, and still apparently believes in his 1981 fiction, that if we simply keep lowering taxes somehow we will collect more.

The fact is David Stockman has made a lot of money, writing in his book, that that was a colossal mistake, an incredible misjudgment, a misjudgment of proportions that probably will not be equalled in decades.

And so, we have to live with that and try and make some sense out of it, and that is what we are trying to do.

Mr. HAEFNER. Well, thank you, Mr. Chairman, for clearing up my misconception about this, but I would only add that we have put a proposal on the table that will get one tiny bit of that $20 billion you are looking for, and maybe there is some more just like it.

Mr. STARK. I appreciate that. Mr. Levin.

Mr. LEVIN. Thank you. Let me probe with the two of you, with Miss Rice and Mr. Powell, the question of the taxation on land or other assets.

There is only one farm I can find in the 17th District that I represent in Michigan, but it is an issue of concern to everybody, everybody.

Let me ask you, though, this. I understand the worry about taxation at death on family farms, but when a family farm is sold, what is the justification for taxing it on the basis of the value subsequent to death rather than what it was purchased for?

When a farm is sold, what is the equity argument? Either of you.

Mr. POWELL. Well, as I understand the capital gains at death takes place at the time that the estate is settled and you pay a dual tax. You pay the estate tax and then a capital gains tax on the increase in value in order to have a carryover basis at that higher level.

So if you implement it in that measure, in that manner, you are tapping the estate for quite a sum of money at that time, and many estates would——

Mr. LEVIN. I mean when it is sold. I am talking about when a farm is sold. It is owned by person 1 and then person 2. Through inheritance it goes to person 3 and then it is sold. Why should the basis be the value at the date of death of person 2?

Mr. POWELL. Well, for one reason, the farm income is approximately 1 or 2 percent of the investment, and if you want farmers to stay in that economic mode you have to give them another incentive.

Mr. LEVIN. Now we are talking about the sale of the farm, now.

Mr. POWELL. That is right. And if he were to sell—how many farmers would you have selling unless they had to? Very few. And in the case where an estate has to be settled those farms are sold, and they would be tapped for an additional capital gains tax.

You do not have many farmers going out unless they have to.

Mr. LEVIN. Ms. Rice, tell me what you think the equity——

Ms. RICE. Let me say two things to follow up on Mr. Powell. I think of the two tax provisions, capital gains at death is more severe for a family, because it is in a situation of where you may have had a significant increase in the value of that land due to inflation which may have been 3 percent, or it may have been 25 percent over the period of time that the property has been held, but nonetheless, a very high capital gains there.

If tax is due at the time of death on that appreciation, the family is not necessarily in a position to go ahead and pay the tax on that appreciation. There has not even been a sale at that point.

Mr. LEVIN. OK. But that was not quite my question. When there is a sale, now why should the basis upon which the gain is determined be that at the time of the death of person 2? I mean what is——

Ms. RICE. On the carryover basis, then.

Mr. LEVIN. Yes. What is the basis for it?

Ms. RICE. Well, I think Mr. Powell alluded to that. These are family operations. The family may have acquired that property generations before. It may have even been homesteaded. It is property that stays in the family and continues to be farmed, no matter what, and generally, even after the death of the decedent it is not property that is sold. It is kept in the family.

Mr. LEVIN. But when it is sold——

Mr. POWELL. I think you will find that most agricultural property, when it is sold, if it is in a true farm family holding, is going to be because of a bankrupt situation or some kind of a catastrophe of that sort.

It is going to remain in the family. These people are farmers.

Mr. DAUB. Would the gentleman yield on that point. As a matter of farm tax law?

Mr. LEVIN. Yes.

Mr. DAUB. The reason we went to a million dollar cap and then phased it up—it is now at $600,000 and we have not reached the cap we originally wanted to in the reform in 1981—for two reasons. One was that if there had to be a sale—seven kids in a family—not just a farm, by the way.

This provision affects small businesses in your town, in your State as well. They would either have to sell part of the business or part of the land to pay the tax. Two taxes. Either an income tax or capital gains, or the inheritance tax, Federal and State, or borrow enough money to pay those taxes and further encumber the business or the land to a point where it would not be profitable for that business or that farm to continue to operate. Thus the exemption, and that is what the debate, really, in terms of tax policy ought to be.

At what point in time do we discourage that business from continuing to operate in the way it has over a period of years, particularly a long number of years where the basis might have been zero, 100 years ago.

Mr. LEVIN. But I do not think that gets at the issue of a subsequent sale. You see, we are going to need to go forth with tax reform if we are going to find the revenues, as well as add revenues.

We are going to have to look for equity, and I think every part of America is going to have to participate in it. The arguments I have heard about the difficulty of obtaining records I do not think get at the issue of equity.

Mr. STARK. The time of the gentleman has expired. Mr. Guarini will inquire.

Mr. GUARINI. Thank you, Mr. Chairman.

Although farming has been a great tradition in our country, I think that what we have seen is that we live in two societies, the free marketplace and the farm society. They are two different worlds, and, as a result, there is a tremendous subsidization that has been going to farmers. Thirty billion dollars last year have gone out to subsidies.

The American taxpayers have subsidized farmers in a lot of other different ways, whether it be in real-estate depreciation or costs of cars, different types of accounting.

We have also given, as we have talked here, different advantages in estate taxes that the normal American does not have, whether or not it is a special payout, or special evaluation. Your evaluations are very, very low, and what is happening is that even with all of these things, the farmers are in a desperate state, and I understand that.

And I am just wondering where we are going to get back on the road to try and have an entirely different approach to our farm system. I, for one, happen to think that if someone wants to live on a farm because he loves the bucolic splendor of living on a farm, but cannot cut it, that he should perhaps find another form of living.

I do not think that America should continue constantly to subsidize farmers that do not want to take up any form of other occupation, even though it is a failing industry.

Now there may be a big debate on that, but we are, eventually, going to be cutting out subsidies in our GATT rounds, and in discussions with other countries, so that we can compete in a free-market world, and farmers can get perhaps the value that they should be getting for their produce.

Things may cost a little bit more, but the taxpayers will be saving in the form of tax dollars, so in the long-run, we might all be that much better off. There will be some competition in the farm market instead of our paying people not to farm.

So I think that what we really have is a system here that is shameful. It does not work. We know it has not worked for a long time, and still, the biggest deficit we have in our budget is the $30 billion that we have to give out to farmers, which is a form of farm welfare, and it does not even help the farmers. They are even worse off for it.

So that you come here looking for different types of considerations in order to be able to make you want to live out there in the farm, and it is really doing very poorly, and you come in here and you say don't cut military spending, don't cut Social Security, don't cut education, don't cut health care, don't cut transportation, don't cut anything, but still, we want to see lower spending because all these waterworks projects and things like that that we give to the farmers are costs that we have from the other part of our society.

And what I am really trying to say is that somewhere along the line we have got to get back on an equilibrium, so the farmer that can farm, productively, can get for his product what he should be able to get.

And also, the Federal Government does not help you because when we cut off grain sales to Russia, Argentina, and other countries up their production, and all that did was just hurt our farmers. So our foreign trade policy has not helped farmers either.

So, in a sense, I feel sorry for the farmers, but in another sense, I think it is about time that we, as a government, had some sensible farm policy that would be able to address our farmers without constant subsidization which is the largest form of subsidization we have in our Tax Code, and yes, I will yield to Mr. Dorgan.

Mr. DORGAN. Frank, thank you for yielding. I just wanted to stop at the point where you talked about the $30 billion representing welfare for farmers. The fact is that the amount of money that we spend in farm support payments is an amount of money that is almost 8 to 10 times more than in 1980–81, and the reason that it is much, much more than it was back then is there has been a deliberate policy to move down the price of farm commodities on the international marketplace. The result is holding price supports at a reasonable level, that is, somewhere near cost of production. The difference between that and the world market price is costing us a great deal of money in support prices.

Mr. GUARINI. And right now we are trying to address that in our GATT so that other countries will not be subsidized.

Mr. DORGAN. That is true. But I guess I just do not want people to think that this is a welfare program that farmers want to see have happen. The farmers would much sooner see a stronger price in the marketplace.

Mr. GUARINI. I agree, but what I am saying is that no matter how you look at it, it is a dole, and it is the biggest part of our deficit, and it is hurting us, and it does not really help the marketplace.

I do think that farmers should be able to get a fair price for their product or they should not produce it. That we should not, as a national policy, be offering money not to grow, and some of the large farmers, and some of the better mechanized farms, are the ones that are perhaps benefiting the most from this. We are giving money to people that do not even need it.

So I think there is a lot that has to be done, and are really rethinking our farm laws out, and our Tax Code could be one area that we can start thinking clearly.

Mr. DAUB. Would the gentleman yield for just a moment?

Mr. GUARINI. Yes.

Mr. DAUB. Just a 30-second shot. In tax reform last year, I am sure the gentleman will recall that farmers were among the most cooperative with investment tax credit, capital gains, and being willing to give up those two things, plus a quick depreciation or ACRS.

We found that it has been an immense help. In other words, those were benefits being used, but we saw the value of bringing the rates down and getting that level playing field the gentleman is talking about.

With respect to the farm bill and its subsidies, most farmers I meet do not want most of their net farm income to come from the Federal Government. They would like the marketplace to produce it, and the folks here testifying today, by and large, have been telling us how they are willing to make some changes to put some revenue back in the Treasury, and I think they ought to be commended for that.

Mr. GUARINI. I just think that $30 billion is outlandish, and if we are talking about our deficit reduction, it is as if almost all the money were given for farm-support prices, so that we would not really be—we would not have the need here of having to raise the $19.3 billion if we had a sensible farm policy in our country.

Mr. DAUB. We are going to take $1.5 billion in reconciliation out of that farm bill.

Mr. DORGAN. And if the gentleman will yield just for a second. If the folks in New Jersey will be willing to pay 2 cents more for wheat in a box of puffed wheat, that will solve the farm problem.

Mr. GUARINI. If you pay as much for our tomatoes——

Mr. DORGAN. The farmer now gets 2 cents in a box of puffed wheat; if they get 4 cents it will solve their problem, and I am sure the folks in New Jersey will not mind paying that. Thank you.

Mr. DAUB. Tomatoes are not subsidized, Mr. Guarini.

Mr. STARK. I would just like to ask a couple of questions in conclusion, if I may.

Mr. Haefner—I am sorry. Mr. Pease.

Mr. PEASE. No, you go ahead.

Mr. STARK. Proceed. I am sorry.

Mr. PEASE. Thank you, Mr. Chairman.

I had to leave for a few minutes and I think you did not see me come back. I would like to pose a question to Ms. Rice. In your

statement you say a capital gains tax at death would also tax inflationary gains unrelated to the productive capacity of the property, and you give an example of how that would happen in the case of an estate or a farm passing from one generation to another.

If a factory worker in Ohio or New Jersey, or elsewhere, gets an increase in his or her wages exactly equal to the inflation rate, the cost of living, and nothing more, then the worker pays income tax on that inflationary increment.

And if a person invests in common stocks, and sells common stocks, and has a capital gain, and pays capital gains on the inflationary component of that gain, I guess the question is why should it be different for farmers? Should they be able to get the advantage of an increase in the value of their property over a period of years, and not ever pay tax on that as long as it is passed from one generation to another?

Ms. RICE. Well, the example we are using here in fact is an acre of land which is a business. It is a capital asset of agriculture. But it is my understanding, in the way that either capital gains at death, or carryover basis has been proposed before, which was approximately 10 years ago, it related to all capital assets which would have been any kind of property whether it was a stock or bond.

Obviously it did not relate to wage ordinary income, though. It was dealing strictly with capital assets.

Mr. PEASE. Well, we are talking about fairness, though, and if the factory worker has to pay taxes on an increase in income which relates to nothing except inflation, and if a person who invests in the stock market has to do the same thing when he sells his stock and realizes the gain, why is it unfair for farmers to pay on their gain, even though part of that gain is due to inflation?

Ms. RICE. Mr. Guarini brought this out a while ago in terms of businesses. Farming is a business, and, frankly, we do not like to look at it in terms of the subsidies that currently accrue to farmers through the farm program.

The Farm Bureau as an organization—and I am sure there are others, too—would prefer to get prices through the marketplace, and you mentioned the GATT proposal. We were very pleased to see that come out. We have endorsed the concept but we have not looked at the specifics yet, but I was glad you brought that up.

Farming, like any small business—or I would say it is not like any small business. You are dealing with vagaries of the markets, you are dealing with the weather. You may have a crop that is here one day and then gone the next, whether it is due to hail, or any other natural disaster. But the point is farmers take tremendous risk, and that land, their capital assets, generally continue from generation to generation to generation.

In the unfortunate circumstances where it does have to be sold it is usually to pay debts related to estate taxes or other debts associated with that property. You run the risk of breaking it up into parcels of the land that are not viable in terms of its efficiency and continued farming operation. And essentially what it does is put that farmer or that small-business person out of business.

I cannot go back and look at the history of the distinction of wages and capital gains. I do not know what was in the mind of the

Congress when it enacted that difference. I can only tell you what our concern is today about the way our principal business asset, which is land, is treated.

Mr. PEASE. Well, farmers are not looking for special treatment, I gather. At least the Farm Bureau is not looking for special treatment for farmers, is that correct?

Ms. RICE. I think every trade association, every lobbyist here today is looking for special treatment of some sort or another, and I think every one of us would acknowledge that fact as we try and represent the interest of our members.

Mr. PEASE. So you are looking for special treatment?

Ms. RICE. We are asking the committee to consider the effect of estate tax changes and the excise tax is the other area that we had mentioned.

Every single tax that the committee could enact will be harmful to someone, and farmers will be included in that group. We just ask the committee to recognize what it will mean for the constituents back in their districts, whether you have farmers or small business.

And I would say, too, we are extremely mindful of the reconciliation requirements that you are under for $19.3 billion in taxes.

Mr. PEASE. I see. Thank you.

Mr. POWELL. Mr. Pease, may I respond also to that question?

Mr. PEASE. Surely.

Mr. POWELL. In terms of an investment, most people who invest in stocks or bonds or real estate like to see at least a 7 or 8 percent return on investment.

Farming is a way of life and those people have an investment in farming, and they are lucky to make 1 percent per annum on their investment.

Now over a period of years, is it too much to ask them to—to ask to receive the treatment of no capital gains on that increase in value for being in that enterprise for that period of time without requesting or requiring that 7 or 8 percent return on investment?

Mr. GUARINI. Will the gentleman yield for a minute. I would just like to make the comment that if anybody on their capital is only making 1 percent, we should query whether or not he is a businessman and whether he should be there.

If a steel industry in Detroit or Pittsburgh is making less than what should be made on their capital, we say in society, if they can't cut it they shouldn't make it. They should not be there.

Now a farm is a business, and it is enterprising, and in my estimation, the problem with the agony and the pain we are going through is that we are trying to treat it as something separate and different and distinct, and that is why I say we have two societies living with one and it does not work out.

All we are doing by giving all these different considerations, in the long-run, is only prolonging the agony of someone who is on a respirator and support systems in the hospital. Sooner or later the patient is going to die.

But if we get with a new system we can do something for the farmer, and I think it is about time we did some new resourceful creative thinking to put farmers back on their feet, not keep doing

the same old tired practices we have had in the past which breaks our budget.

Mr. DAUB. Mr. Pease, would you give me 30 seconds.

Mr. STARK. The time of the gentleman has expired, and it is now the Chair's turn.

Mr. Haefner and Mr. Thomas, do both of your companies grow chickens?

Mr. HAEFNER. Yes, we do.

Mr. THOMAS. Yes.

Mr. STARK. Are they both public companies?

Mr. HAEFNER. Yes.

Mr. THOMAS. Yes.

Mr. STARK. So you could tell me, roughly, in 1986—roughly—what were your sales? For ConAgra?

Mr. HAEFNER. ConAgra was about $8 billion.

Mr. STARK. $8 billion?

Mr. HAEFNER. Yes.

Mr. STARK. And the Federal Co.?

Mr. THOMAS. $1.4 billion.

Mr. STARK. $1.4 billion. And you paid some tax at Federal. Did you tell us how much or is that——

Mr. HAEFNER. Well, I can only tell you that in the most recent year, on a current liability ConAgra paid a 37 percent in 1986 and an over 41 percent in 1987. So that is the effective tax rate.

Mr. STARK. Is this what you are getting at—and this applies more to Federal—it sounds like ConAgra is sort of a giant of the industry. Is that fair or not?

Mr. HAEFNER. Well, from the poultry standpoint, if I may digress for just a moment, Mr. Chairman, we are the second-largest poultry company.

Mr. STARK. Who is the largest?

Mr. HAEFNER. The largest is Tyson, a public company.

Mr. STARK. How much did they sell last year?

Mr. HAEFNER. About $1.7 billion. Now our poultry company was only $1.3 billion.

Mr. STARK. That is what I wanted to get at; $1.3 billion. Well, what I am reading here is, that while you were guys were paying taxes, Pilgrim Pride, in 1986, got exemption from taxes of $27.5 million, and Tyson was exempting under this deferral $103 million, and that sounds, to me, on their sales of a billion, that they got a 10-percent headstart on you.

What is the margin in the poultry business?

Mr. HAEFNER. Well, the margin in the poultry business is, Mr. Chairman, very variable. We have some loss years and some profit years, as a percent, maybe as 2 or 3 percent, but——

Mr. STARK. So it is kind of hard competing against the guy with a 10-percent headstart?

Mr. HAEFNER. It is hard to compete with someone who has got a $120-million tax deferral upon which there—it is capital for use with no interest expense.

Mr. STARK. And Hudson Foods had about almost $12 million in tax deferrals. I want to hasten to point out that these are all public figures, and I am not giving out any information that is not available to the public at large.

But your issue, as I understand, Mr. Thomas and Mr. Haefner, is why should these companies—which are hardly itty-bitty family farms, any more than the families of Prudential and Tenneco, who farm in my State—Ma and Pa Tenneco and Mr. and Mrs. Prudential make a good bit of money farming in the central part of California, and they might like to be family farms, too, but they are not. And that is——

Mr. HAEFNER. That is the crux of our argument.

Mr. STARK. I could not agree more and I just wanted to see if I could get right down to what was pestering you. I wanted to see if Mr. Powell would try something with me.

Lets say you had a son, or a daughter, or a niece or nephew, or grandson, granddaughter. And let's remember back, if we can, to years when the cattle business was okay in west Texas and you could do a little more than a percent or two. What could a person buy a good-sized cattle operation for? How many millions of dollars?

Mr. POWELL. How many years back?

Mr. STARK. The last few years you remember when the market was good.

Mr. POWELL. Well, in our county, an economic unit where a man made about what a New York taxi driver would make, it takes 5,000 acres.

Mr. STARK. And how much could you buy a 5,000 acre operation for and make your $15,000 to $20,000 a year?

Mr. POWELL. Five years ago. Oh, it will take $1.5 million at least.

Mr. STARK. Okay. So for $6 million you could buy a pretty nice operation and make maybe a living on it?

Mr. POWELL. Well, you could be comfortable, equal perhaps to——

Mr. STARK. What I am getting at is if you or I wanted to put our son or daughter in business, under the Tax Code now, if you left them that kind of an operation, they would only have to pay 3 percent on $2 million, interest only—that is $120,000 a year—and they have got the $6 million operation free.

Now you would kind of think that you raised some kind of a dummy that could not take a $6 million operation and make it under those terms. As a matter of fact it sounds almost too generous for me, because I, not being a farmer, cannot leave that to my children.

And that is the kind of thing that bothers me. You exempt the first million, two, and even that is at a lower rate. Then you give them 4 percent on the first million, the inheritance tax cannot be 50 percent of the balance over the million, two. There just is no way that those terms are even fair, and I am just saying that I think we all think our kids are independent and can make it, but when you give them that much of a head start, my question is what is wrong with their paying a few taxes, just like you had to do along the way?

Mr. POWELL. Well, of course I think the tax on $6 million would be a great deal more than that if I passed it on to my children.

Mr. STARK. No. They would hardly come to $2 million. If you got married to have the children, and you and your wife could each take the $600,000 exemption, and then you pay the tax, it might

hit 50 percent, and after you valued it at the low farming rate it probably would not be $2 million in taxes. The first million, you would only pay 4 percent interest, interest only for 4 years, and 8 percent on the other million.

That comes on the total, $6 million, to about 3 percent.

Mr. POWELL. Well, it would be difficult to make the estate taxes out of that property, operating property alone. There are many young people in my county who are attempting that, and they are having to seek other means of survival in addition to the ranching business.

Mr. STARK. Thank you very much.

Any other members? If not, we will thank the panel very much for their patience and their cooperation, and call the next panel which consists of James A. Joseph, president and chief executive officer of the Council on Foundations; Brian O'Connell, the president of Independent Sector; Mahlon Hessey, a member of the board of trustees of the Shriners Hospitals; and Elissa Matulis Myers, the director of member services, the American Society of Association Executives.

And I would admonish this panel, as I have the others, and my colleagues on the committee, if you could summarize or expand on your statement in 5 minutes, or less, we would appreciate it very much.

When you are seated, Mr. Joseph may begin.

Mr. RANGEL [presiding]. I assume the chairman has indicated that because of the number of witnesses and panels that we are on the 5-minute rule, which is indicated by the lights, that without any objection from the committee, all statements that the witnesses have, by unanimous consent will be entered into the record, and we will start with the Council on Foundations, Jim Joseph, president and chief executive officer, who has made a major contribution to the formation of existing law as it relates to foundations. Thank you for being with us.

STATEMENT OF JAMES A. JOSEPH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COUNCIL ON FOUNDATIONS, INC.

Mr. JOSEPH. Mr. Chairman, it is a pleasure to see you and to testify before you again. Members of the committee, and Mr. Chairman, my name is James A. Joseph.

I am president of the Council on Foundations, organized in 1949 to promote responsible and effective grantmaking. The council shares with the Congress a desire to ensure that the public interest is well served.

We now have within the membership of the council more than one thousand grantmaking organizations. They presently hold over 50 percent of all foundation assets, now estimated at approximately $88 billion nationwide.

Our membership includes 760 private foundations which currently pay a 2 percent excise tax, and 195 community foundations which pay no excise tax. Therefore, we are greatly concerned about any public policy considerations that would introduce a brandnew tax on the income of community foundations, and, at the same time, increase the excise tax on private foundations by 150 percent.

Mr. Chairman, I would just simply submit for the record the information I have in my testimony about the contributions of foundations, and I want to briefly introduce five very quick points that I think the committee ought to consider as it looks at possibilities for additional revenues.

First of all, Mr. Chairman, a foundation's resources for support of charitable purposes come primarily from endowment income. We are here therefore dealing with the lifeblood of the charitable stream that has provided support for programs which benefit the poor, the elderly, students, hospital patients, the environment, and countless other charitable purposes.

Second, an excise tax on foundations is really a tax on charities supported by foundations. Each dollar of tax revenue collected by the Government reduces by one dollar the amount which foundations have available to distribute annually for charitable purposes.

In fiscal year 1986, the Internal Revenue Service collected over $217 million from private foundations based on a 2 percent excise tax. Raising this tax to 5 percent would reduce the grantmaking capacity of private foundations by an additional 150 percent, or $326 million annually.

Community foundations pay no excise tax. We estimate, conservatively, that our 195 community foundation members would lose nearly $13 million in grantmaking capacity if faced with a new 5 percent excise tax.

In short, Mr. Chairman, a tax on foundations is really a tax on the charities to which these foundations make grants. We estimate that a 5 percent excise tax on all foundations would reduce grants by over $350 million annually.

Third, the existing tax on private foundations has been generally regarded as a user fee. In the fall of 1969 when the Senate Finance Committee was beginning consideration of what became the Tax Reform Act of that year, the Treasury Department presented testimony arguing that it would not be appropriate to limit the funds available for charitable purposes by imposing a tax greater than the amount which would be sufficient to offset the enforcement efforts undertaken by the Internal Revenue Service.

Subsequent revisions of section 4940 of the code have all been aimed at maintaining the concept of an excise tax as a user fee. At a time in which we are already seeing millions of dollars lost from the charitable stream by the existence of a 2 percent excise tax, it would clearly not be in the public interest to multiply that by 150 percent.

My fourth point is simply this: A reduction in private funds available to support charitable organizations shifts the burden from the private to the public sector. Federal tax exemption has always reflected the recognition that foundation grants support programs that lessens the burdens of Government, programs that would otherwise have to be financed out of tax revenues.

Finally, one must ask whether a foundation is really tax-exempt if it is taxed beyond the cost of audit or oversight. In 1969, both the Senate and the House decided that to alleviate any misunderstanding of congressional intent, they would define the tax as an excise tax rather than an income tax.

It is now clear that an excise tax which goes beyond the user fee for audit would be a significant modification of the Federal policy on tax exemption. Since the inception of the tax statute, Members of the Congress have usually stood strongly against any effort to modify the tradition of encouraging private individuals and private institutions to use private resources for public purposes.

A 5 percent excise tax on the investment income of foundations would clearly be a reversal of a longstanding tradition and contrary to the public interest. Thank you.

[The statement of Mr. Joseph follows:]

TESTIMONY OF

JAMES A. JOSEPH

PRESIDENT
COUNCIL ON FOUNDATIONS

BEFORE THE

WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

HEARINGS ON REVENUE INCREASE OPTIONS

Wednesday, 9:30 a.m.
July 8, 1987

Room 1100
Longworth House Office Building

MR. CHAIRMAN, members of the Committee, my name is James A. Joseph, and I am President of the Council on Foundations. Organized in 1949 to promote responsible and effective grantmaking, the Council shares with the Congress a desire to ensure that the public interest is well-served. We now have within our membership more than 1,000 grantmaking organizations. They presently hold over 50 percent of all foundation assets now estimated at approximately $88 billion nationwide. Our membership includes 760 private foundations which currently pay a 2 percent excise tax and 195 community foundations which pay no excise tax whatsoever. Therefore, we are greatly concerned about any public policy consideration that would introduce a brand new tax on the income of community foundations and -- at the same time -- increase the excise tax on private foundations by 150 percent.

Contributions of Foundations

Private and community foundations are a reflection of the enduring American idea that a good society depends as much on the goodness of individuals as it does on the soundness of government and the fairness of laws. It is fitting, therefore, to remind ourselves of the contributions of foundations over the years. Even a limited glimpse of this history reveals such landmarks as:

- Early assistance to Dr. Jonas Salk's polio-vaccine research
- Foundation-sponsored research instrumental in greatly reducing or eliminating other international diseases such as typhoid and yellow fever, malaria and tuberculosis
- Development of a network of free public libraries now in use in cities across the United States and Canada

But in addition to those widely celebrated contributions, foundations in many communities are presently using the investment income from their endowments to address a wide variety of problems that would otherwise go unmet. Among the grants highlighted in the Council on Foundations publication, How We Helped, 1986 are these:

- Early in 1986, the Robert Wood Johnson Foundation announced a $17 million Health Services Program to help urban hospitals deal with the problem of AIDS.
- In the latter months of 1986, as national concern about drug abuse intensified, many foundations responded with grants like the one made here in Washington by the Community Foundation of Greater Washington to the Regional Addiction Prevention Center.
- A $75,000 challenge grant from the Kresge Foundation to the Wilderness Road Girl Scouts Council (WRGSC) was instrumental in raising a total of $600,000 for construction of a service center. The Council and its new center provide programs for 57 Kentucky counties including troops for handicapped and delinquent girls.

These grants, like others to house the homeless and feed people who are hungry, all come out of the investment income of foundations.

Five Important Points

I would, therefore, offer five brief but very important points for this Committee's consideration as you examine whether an excise tax on the net investment income of exempt organizations is good public policy.

#1 — Income from endowment is the major source of funds for foundation grantmaking

First of all, Mr. Chairman, a foundation's resources for support of charitable purposes come primarily from endowment income. We are here dealing with the lifeblood of the charitable stream that has provided support for programs which benefit the poor, the elderly, students, hospital patients, the environment and countless other charitable purposes.

#2 — A tax on foundations is a tax on charities

Secondly, an excise tax on foundations is really a tax on charities supported by foundations. Each dollar of tax revenue collected by the government reduces by one dollar the amount which foundations have available to distribute annually for charitable purposes.

In Fiscal Year 1986 the Internal Revenue Service collected over $217 million from private foundations based on a 2 percent excise tax (a few foundations were eligible for a 1 percent tax). Raising this tax to 5 percent would reduce the grantmaking capacity of private foundations by an additional 150 percent, or $326 million annually.

Community foundations pay no excise tax. We estimate conservatively that our 195 community foundation members would lose nearly $13 million in grantmaking capacity if faced with a new 5 percent excise tax.

In short, Mr. Chairman, a tax on foundations is really a tax on the charities to which they make grants. We estimate that a 5 percent excise tax on all foundations would reduce grants by over $350 million annually.

#3 — Current excise tax is a user tax

Third, the existing tax on private foundations has been generally regarded as a user fee. In the fall of 1969, when the Senate Finance Committee was beginning consideration of what became the Tax Reform Act of that year, the Treasury Department presented testimony arguing that it would not be appropriate to limit the funds available for charitable purposes by imposing a tax greater than the amount which would be sufficient to offset the enforcement efforts undertaken by the IRS. Subsequent revisions of Section 4940 of the Internal Revenue Code have all been aimed at maintaining the concept of an excise tax as a user fee rather than an income tax on tax-exempt organizations.

Despite this clear intent, the present 2 percent excise tax generates revenue over 21 times the cost involved in the audit of private foundations. In fact, in 1983 the IRS testified that the total cost of running the entire Exempt Organizations Division was only $33.4 million. At a time, therefore, in which we are already seeing millions of dollars lost from the charitable stream by the existence of a 2 percent excise tax on private foundations, it would clearly not be in the public interest to multiply that amount by 150%. Even if it is accepted that foundations ought to bear the cost of IRS supervision, the present tax is excessive and harmful to the charitable organizations that depend on foundation grants for their survival.

#4 — The tax will increase burden on government

My fourth point is simply this: a reduction in private funds available to support charitable organizations shifts the burden to the public sector. Federal tax exemption has always reflected the recognition that foundation grants support programs that lessen the burdens of government, programs that would otherwise have to be financed out of tax revenues.

#5 — The traditional tax policy of not taxing the income of tax exempt organizations should be preserved

Finally, one must ask whether a foundation is really tax-exempt if it is taxed beyond the cost of audit or oversight. In 1969, the Senate Finance Committee was especially concerned that the form of the tax adopted by the House would lead some to believe that foundations were no longer tax-exempt. To alleviate any misunderstanding of Congressional intent, the Senate and later the House cast the tax as an excise tax rather than an income tax.

It is now clear that an excise tax which goes beyond the user fee for audit would be a significant modification of the Federal policy on tax-exemption. Since the inception of the tax statute, members of the Congress have usually stood strongly against any effort to modify the tradition of encouraging private individuals and private institutions to use private resources for public purposes. A 5 percent excise tax on the investment income of private foundations would clearly be a reversal of a long-standing tradition and contrary to the public interest. It is precisely because huge budget deficits will continue to cause reductions in public revenues that we need every private dollar we can get to support and keep alive the voluntary sector that has served our nation so well.

Mr. STARK. Thank you. Mr. O'Connell.

STATEMENT OF BRIAN O'CONNELL, PRESIDENT, INDEPENDENT SECTOR

Mr. O'CONNELL. Thank you. During the past 6 years nonprofit organizations have faced three major crises. The first involved the reductions in Federal spending, particularly in the human services, which added greatly to the expectations for service of voluntary organizations.

The second crisis came at the very same time because the Government was cutting back on its own services, or support for services. It was, in essence, transferring that responsibility to voluntary organizations, but at the same time it cut its share of the public/private partnership.

So the burden was being transferred and the dollars were being cut. Let me be very specific in that regard. Reduction in direct Federal support of the services of voluntary organizations for fiscal years 1982–86 amounted to $23 billion or 27-percent reductions, at a time when increased services were expected.

Another important fact out of an Urban Institute study points out that for private giving to have made up for the Government reductions in the areas of our public/private partnerships would have required giving to grow at seven to eight times the level, the highest level it had achieved in previous years.

A third major crisis involves the Tax Reform Act recently considered here, which you have acknowledged, and it is clear makes raising money much harder. The combination of reduced rates, the elimination of the deduction for the nonitemizer, and the gifts of appreciated property in the calculation of income in the alternate minimum tax, combined, according to Prof. Lawrence Lindsey of Harvard, and the National Bureau of Economic Research, caused an impact on annual giving of approximately $11 billion or 15 percent.

Throughout the tax reform process we were told very much in this room, and in the Senate Finance Committee, that everyone had to accept a share in the cost of the burden of tax reform, but I submit that we have been trying to make the case, again and again to you, that the combination of budget and tax impacts on voluntary organizations was not and is not equitable.

It is certainly not fair for the Government to transfer some of its service load to voluntary organizations, then cut its share of the existing partnership, and to top it all off, to undermine our ability to raise money.

Now, almost unbelievably, a Joint Committee report comes along that serves up the idea of a new excise tax on our organizations. The report says that this new tax could raise $3.5 billion in 1988 of which at least $1 billion would come out of the capacity of voluntary organizations and foundations to perform their public service.

On top of that billion dollar loss, the Joint Committee offers that itemized deductions might be allowed only against the 15 percent tax rate. This proposal alone would cost charitable organizations about $6 billion annually.

Beyond all of this is a matter of principle. This excise tax is contrary to the underlying concept of tax exemption. As Jim Joseph has pointed out, in 1969 Congress imposed that 4 percent tax on the income of foundations, under the rationale and under the assurance that that money would be used only to monitor the activities of foundations. That tax was reduced in 1979 to 2 percent, but still produces $217 million a year, which is six times the total budget of the whole exempt division of IRS.

I submit that to tax tax-exempt organizations is fundamentally a contradiction. It is the ultimate in oxymorons. There are several other provisions in the Joint Committee's documents such as increase in the alternate minimum tax from the present 21 to 25 percent; initiation of a 10 percent floor on aggregate itemized deductions for certain taxpayers; and an across-the-board reduction in individual tax preferences which would have a negative effect on the income of nonprofit organizations.

These reductions, and others mentioned above, totalled $9 billion. We implore you to establish at the outset of your considerations a principle and a determination not to do anything further to reduce the capacity of voluntary organizations to fulfill their public service.

The Government asked us, you asked us, to take a larger share of the human-service load. You dealt us an inordinate share of the burden of tax reform, and I think it's fair to conclude that enough is enough. Thank you.

[The statement of Mr. O'Connell follows:]

TESTIMONY OF BRIAN O'CONNELL
President, INDEPENDENT SECTOR

I am Brian O'Connell, President of INDEPENDENT SECTOR, a membership organization of 654 national voluntary associations, foundations, and corporate giving programs. A list of our members is attached.

During the past six years nonprofit organizations have faced three major crises:

1. Reductions in federal spending, particularly for human services, caused the caseloads and expectations for services of voluntary organizations to increase crushingly.

2. At the very time the government was transferring to nonprofits greater responsibility for services, the same government reduced dramatically its financial support for such services. According to the Urban Institute report, The Nonprofit Sector and the Federal Budget:

   a. For the primary service areas where there has been a traditional public/private partnership, financial support was reduced by $70 billion* or 14 percent for the fiscal years 1982-86.

   b. Reduction in direct federal support of the services of voluntary organizations for those same years was $23 billion or 27 percent.

   c. For private giving to make up for the government's reductions would have required giving to grow at a rate seven to eight times higher than the peak rate it has achieved in recent years.

3. The Tax Reform Act of 1986 made the raising of contributed funds more difficult. The combination of reduced rates, the elimination of the charitable deduction for nonitemizers, and the inclusion of gifts of appreciated property in the definition of income for the alternate minimum tax will, according to Professor Lawrence Lindsey of Harvard and the National Bureau of Economic Research, cause an impact on annual giving of approximately $11 billion or 15 percent. To try to offset some of this loss, INDEPENDENT SECTOR has just launched an initial five-year effort to try to increase the total amount that individuals contribute to the causes of their choice.

Throughout the tax reform process, we were told that everyone had to share the burden, but we have been trying to point out that the combination of budget and tax impacts on voluntary organizations is not equitable. It is certainly not fair for the government to transfer some of its service load to us, then cut its share of the partnership and, on top of it all, to undermine our ability to raise money.

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* Exclusive of Medicare and Medicaid funding.

Now, along comes a Joint Committee report that serves up the idea of a new excise tax on exempt organizations which it says could raise $3.5 billion in 1988, of which at least $1.5 billion would come out of the program and granting capacity of voluntary organizations and foundations. On top of that $1.5 billion loss, the Joint Committee proposes that the deduction for itemized deductions could be allowed only against the 15 percent tax rate. This proposal alone would reduce charitable giving by another $6.7 billion annually according to research by Professor Lindsey.

For the Federal Government to consider slashing another $8-9 billion or 10 percent, or any substantial proportion from the income of the sector to which it is transferring so much of the service burden is absurd and cruel.

Beyond all of that, this excise tax is contradictory to the underlying concept of tax-free organizations. In 1969, Congress imposed a four percent excise tax on foundations under the rationale that the income would be used to monitor the work of foundations. That tax was reduced in 1979 to two percent but still produces $217 million a year (1986) which is six times the total budget of the entire exempt division of IRS. I believe that there is solid ground to question the imposition of any excise tax on exempt organizations, even for monitoring, and that to begin to tax tax-exempt organizations is fundamentally a contradiction.

There are several other provisions in the Joint Committee's document, such as an increase in the alternate minimum tax from the present 21 percent to 25 percent, initiation of a 10 percent floor on aggregate itemized deductions for certain taxpayers, and an across-the-board reduction in individual tax preferences, which would have a negative effect on the income of nonprofit organizations. These reductions and the others mentioned above, total $9.617 billion, as follows:

5% excise tax	$ 1.5 billion	
Allow itemized deductions only at 15% rate	6.7 billion	
25% alternative minimum tax		$221 million
10% floor		346 million
Added preferences		42 million
Total	$ 9.617 billion	

We implore you to establish at the outset a principle and a determination not to do anything further to reduce the capacity of voluntary groups to fulfill their public service. The government asked us to take a larger share of human services and then dealt us an inordinate share of the burden of tax reform. Enough is enough.

List of INDEPENDENT SECTOR Members

(As of June 16, 1987)

IS VOTING MEMBERS

A Presidential Classroom for Young Americans
AAFRC Trust for Philanthropy
ACCESS: Networking in the Public Interest
ACCION International/AITEC
ALS Association
AMVETS National Service Foundation
ARCO Foundation
ARROW
ASPIRA of America
AT&T Foundation
Accountants for the Public Interest
Aetna Life and Casualty Company
Affiliated Leadership League of and For the Blind of America
African Wildlife Foundation, Inc.
Aga Khan Foundation U.S.A.
Aid Association for Lutherans
Aid to Artisans, Inc.
Alcoa Foundation
Alliance of Independent Colleges of Art
Allied Corporation
Allstate Foundation
American Arts Alliance
American Assembly
American Association for Higher Education
American Association for Museum Volunteers
American Association for the Advancement of Science
American Association of Community and Junior Colleges
American Association of Fund-Raising Counsel, Inc.
American Association of Homes for the Aging
American Association of Museums
American Association of University Students
American Association of University Women
Primerica Corporation Foundation
American Cancer Society
American Citizens Concerned for Life
American Committee on Africa
American Council for Judaism
American Council for the Arts
American Council of Learned Societies
American Council on Alcoholism
American Council on Education
American Craft Council
American Dance Guild, Inc.
American Diabetes Association, Inc.
American Ditchley Foundation
American Express Foundation
American Farmland Trust
American Fisheries Society
American Foundation for the Blind, Inc.
American Hospital Association
American Humanics, Inc.
American Institute for Cancer Research
American Leadership Forum
American Library Association
American Lung Association
American ORT Federation, Inc.
American Public Radio
American Red Cross
American Social Health Association
American Stock Exchange, Inc.
American Symphony Orchestra League
American Woman's Economic Development Corporation
American-Standard Foundation
Americans for Indian Opportunity
Amfac, Inc.
Amoco Foundation, Inc.
Anschutz Family Foundation
Appalachian Mountain Club
Arca Foundation
Art Museum Association
Arthritis Foundation
Aspen Institute for Humanistic Studies
Association for International Practical Training

Association for Volunteer Administration
Association of American Colleges
Association of American Universities
Association of American University Presses
Association of Art Museum Directors
Association of Black Foundation Executives
Association of Governing Boards of Universities and Colleges
Association of Hispanic Arts Inc.
Association of Independent Conservatories of Music
Association of Jesuit Colleges and Universities
Association of Junior Leagues, Inc.
`ssociation of Professional Vocal Ensembles
Association of Science Technology Centers
Association of Voluntary Action Scholars
Avon Products Foundation, Inc.
B'nai B'rith International
Mary Reynolds Babcock Foundation
Ball Brothers Foundation
BankAmerica Foundation
Bankers Trust Company
Beatrice Companies, Inc.
Bell Atlantic
BellSouth
Benton Foundation
Beverly Foundation
Big Brothers/Big Sisters of America
Bing Fund Corp.
Blandin Foundation
Boeing Company
Borden Foundation
Boston Foundation
Boston Globe Foundation, Inc.
Botwinick-Wolfensohn Foundation
Boy Scouts of America
Boys Clubs of America
Bread for the World Educational Fund, Inc.
Otto Bremer Foundation
Bristol-Myers Fund, Inc.
Brookings Institution
Brother's Brother Foundation
Brown Foundation, Inc.
Brunswick Foundation, Inc.
Burlington Industries Foundation
Burroughs Corporation
Burroughs Wellcome Fund
Edyth Bush Charitable Foundation, Inc.
Business Committee for the Arts, Inc.
CARE
CBS Inc.
CEIP Fund, Inc.
CODEL - Coordination in Development, Inc.
CPC International, Inc.
Cabot Corporation Foundation
California Community Foundation
Call for Action, Inc.
Camp Fire, Inc.
Carnegie Corporation of New York
Carnegie Foundation for the Advancement of Teaching
Carroll Center for the Blind
Carter Hawley Hale Stores, Inc.
Castle & Cooke, Inc.
Catalyst for Women, Inc.
Caterpillar Foundation
Catholic Charities USA
Center for Corporate Public Involvement
Center for Creative Leadership
Center for Creative Management
Center for the Study of the Presidency
Center to Prevent Handgun Violence
Champion International Corporation
Chase Manhattan Bank, N.A.
Chesebrough-Pond's Inc.
Chevron U.S.A., Inc.
Chicago Tribune Foundation
Child Care Action Campaign

Children's Aid International
Christian Church Foundation
Christian Ministries Management Association
Church Women United
Citicorp/Citibank
Citizens' Scholarship Foundation of America
Civic Education Foundation
Edna McConnell Clark Foundation
Cleveland Foundation
Clorox Company Foundation
Close Up Foundation
Coca-Cola Foundation
College Board
Colonial Williamsburg Foundation
Columbia Foundation
Committee for Food and Shelter
Commonwealth Fund
Community Foundation for Southeastern Michigan
Community Foundation of Greater Washington DC
Congressional Award Foundation
Connecticut Mutual Life Insurance Company
Conoco, Inc.
Conservation Fund
Consortium for the Advancement of Private Higher Education
Corning Glass Works Foundation
Coro Foundation
Corporation for Enterprise Development
Council for Advancement and Support of Education
Council for Aid to Education
Council for American Private Education
Council for the Advancement of Citizenship
Council of Better Business Bureaus/ Philanthropic Advisory Service
Council of Independent Colleges
Council of Jewish Federations
Council on Economic Priorities
Council on Foundations
Council on International and Public Affairs
Council on Library Resources, Inc.
Crown-Zellerbach Foundation
Cystic Fibrosis Foundation
Charles A. Dana Foundation, Inc.
Dance/USA
Edwin W. and Catherine M. Davis Foundation
Dayton Hudson Foundation
Deere and Company
Defenders of Wildlife
Denver Foundation
Geraldine R. Dodge Foundation
Dole Foundation for Employment of Persons with Disabilities
Gaylord and Dorothy Donnelley Foundation
William H. Donner Foundation, Inc.
Joseph Drown Foundation
E.I. DuPont de Nemours and Co.
Duke Endowment
Durfee Foundation
Dyson Foundation
Earthwatch
Eastman Kodak Company
Eaton Corporation
Ecolab Inc.
Education Network for Older Adults
Educational Assistance Ltd.
Eisenhower Foundation
Elderworks, Inc.
Emerson Electric Company
Enterprise Foundation
Environmental Fund
Environmental Law Institute
Epilepsy Foundation of America
Equitable Life Assurance Society of the United States
Evangelical Council for Financial Accountability
Exxon Corporation

Maurice Falk Medical Fund
Family Service America
Federated Department Stores, Inc. Foundation
Federation of State Humanities Councils
First Bank System Foundation
Food Research and Action Center
Food for the Hungry, Inc.
Ford Foundation
Ford Motor Company Fund
Foreign Policy Association
Forty Plus Educational Center, Inc.
Foundation Center
Foundation for Children with Learning Disabilities
Foundation for Exceptional Children
Foundation for Teaching Economics
Foundation for the Carolinas
Foundation for the Peoples of the South Pacific, Inc.
Fresh Air Fund
Friends Association for Higher Education
Fuller Foundation
Fund for Artists' Colonies
Fund for New Jersey
Fund for New Jersey
Fund for an OPEN Society
GTE Foundation
Gannett Foundation
General Conference of Seventh-day Adventists
General Electric Company
General Foods Corporation
General Mills Foundation
General Motors Foundation
General Service Foundation
Georgia-Pacific Foundation, Inc.
Wallace Alexander Gerbode Foundation
J. Paul Getty Trust
Giraffe Project
Girl Scouts of the U.S.A.
Girls Clubs of America, Inc.
Morris Goldseker Foundation of Maryland, Inc.
Goodwill Industries of America
Grace Foundation, Inc.
GrandMet USA, Inc.
Grantmakers in Health
Lucile & Robert H. Gries Charity Fund
Grotto Foundation
Grumman Corporation
Gulf + Western Foundation
George Gund Foundation
Alan Guttmacher Institute
Miriam and Peter Haas Fund
Walter and Elise Haas Fund
Evelyn and Walter Haas, Jr. Fund
Habitat for Humanity, Inc.
Hallmark Cards, Inc.
Luke B. Hancock Foundation
James G. Hanes Memorial Fund/ Foundation
Harris Foundation
Hartford Insurance Group Foundation
Hawaiian Foundation
Edward W. Hazen Foundation
Healing Community
William Randolph Hearst Foundation
H.J. Heinz Company Foundation
Heublein Foundation
William and Flora Hewlett Foundation
Hillman Foundation, Inc.
Conrad N. Hilton Foundation
Hispanic Policy Development Project
Hitachi Foundation
Hoffmann-LaRoche Foundation
Hogg Foundation for Mental Health
Honeywell Foundation
Hospital Research and Educational Trust

Hudson Webber Foundation
Hunt Foundation
Huntington's Disease Foundation of America
Godfrey M. Hyams Trust
IBM Corporation
INTERPHIL (International Standing Conference on Philanthropy)
Independent College Funds of America, Inc.
Independent Research Libraries Association
Institute for Journalism Education
Institute for Nonprofit Organization Management
Institute of Current World Affairs
InterAction (American Council for Voluntary International Action)
International Assn. of Psychosocial Rehabilitation Services
International Christian Youth Exchange
The International Exchange Association
International Fund for Animal Welfare
International Paper Company Foundation
International Primate Protection League
International Women's Health Coalition
Interracial Council for Business Opportunity
James Irvine Foundation
Irving Trust Company
Ittleson Foundation
JWB
Japan-America Student Conference, Inc.
Jerome Foundation
Johnson & Johnson
Johnson Foundation, Inc.
Robert Wood Johnson Foundation
Joint Center for Political Studies
Joint Council on Economic Education
Jostens Foundation, Inc.
Joyce Foundation
Junior Achievement Inc.
K Mart Corporation
Henry J. Kaiser Family Foundation
Keep America Beautiful, Inc.
W.K. Kellogg Foundation
John F. Kennedy Center for the Performing Arts
John F. Kennedy Library Foundation
Charles F. Kettering Foundation
Kiplinger Foundation
Knight Foundation
Kraft, Inc.
Kresge Foundation
Samuel H. Kress Foundation
Albert Kunstadter Family Foundation
LAOS, Inc./Partners for Global Justice
League of Women Voters Education Fund
Sara Lee Foundation
Leukemia Society of America, Inc.
Lilly Endowment, Inc.
Eli Lilly and Company
Literacy Volunteers of America
Los Angeles Women's Foundation
Lubrizol Foundation
Henry Luce Foundation
Lutheran Brotherhood Foundation
Lutheran Council in the USA
Lutheran Resources Commission - Washington
Lyndhurst Foundation
MATHCOUNTS Foundation/NSPE Education Foundation
John D. and Catherine T. MacArthur Foundation
Make-A-Wish Foundation of America
March of Dimes Birth Defects Foundation
John and Mary R. Markle Foundation
McAuley Housing Foundation
Robert R. McCormick Charitable Trust
McGraw-Hill Foundation
McGregor Fund
McKesson Foundation, Inc
Meadows Foundation

Meals for Millions/Freedom from Hunger Foundation
Medina Foundation
Medtronic Foundation
Richard King Mellon Foundation
Merrill Lynch and Company Foundation, Inc.
Metropolitan Life Foundation
Mexican American Legal Defense and Educational Fund
Eugene and Agnes E. Meyer Foundation
John Milton Society for the Blind
Minneapolis Foundation
Mobil Oil Corporation
Monsanto Company
Philip Morris, Inc.
Stewart R. Mott Charitable Trust
Charles Stewart Mott Foundation
Mountain Bell Foundation
Ms. Foundation for Women, Inc.
Mutual Benefit Life
Mutual of America Life Insurance Company
NAACP Legal Defense and Educational Fund
NOW Legal Defense and Education Fund
NYNEX
National 4-H Council
National Academy of Public Administration
National Action Council for Minorities in Engineering
National Alliance for the Mentally Ill
National Alliance of Business
National Assembly of Local Arts Agencies
National Assembly of Nat'l. Vol. Health and Social Welfare Org. Inc.
National Assembly of State Arts Agencies
National Association for Bilingual Education
National Association for Hispanic Elderly
National Association for Hospital Development
National Association for Visually Handicapped
National Association for the Advancement of Colored People
National Association of College and University Business Officers
National Association of Community Health Centers, Inc.
National Association of Homes for Children
National Association of Independent Colleges and Universities
National Association of Independent Schools
National Assn. of Latino Elected and Appointed Officials (NALEO)
National Association of Private Schools for Exceptional Children
National Association of Public Television Stations
National Association of Schools of Art and Design
National Association of Schools of Music
National Association of Schools of Public Affairs and Administration
National Association of United Methodist Foundations
National Association on Drug Abuse Problems, Inc.
National Audubon Society
National Bureau of Economic Research
National Catholic Development Conference, Inc.
National Center for Urban Ethnic Affairs
National Charities Information Bureau, Inc.
National Child Labor Committee, Inc.
National Committee For Adoption, Inc.
National Committee for Citizens in Education
National Committee for the Prevention of Child Abuse
National Concilio of America
National Congress for Community Economic Development
National Congress of Parents and Teachers
National Consumers League, Inc.
National Corporate Fund for Dance, Inc.
National Corporate Theatre Fund
National Council for International Visitors
National Council for Research on Women
National Council of La Raza
National Council of Senior Citizens
National Council of Women of the United States
National Council of the Churches of Christ in the USA
National Council on Alcoholism, Inc .
National Down Syndrome Society
National Easter Seal Society, Inc.
National Education Association
National Executive Service Corps
National FFA Foundation

National Family Planning and Reproductive Health Association
National Federation of Business and Professional Women's Clubs, Inc.
National Fish and Wildlife Foundation
National Foundation for Long Term Health Care
National Fund for Medical Education
National Future Homemakers of America
National Gardening Association, Inc.
National Headache Foundation
National Health Council
National Hispanic Scholarship Fund
National Home Library Foundation
National Hospice Organization
National Image, Inc.
National Indian Youth Council
National Institute for Dispute Resolution
National Job Corps Alumni Association, Inc.
National Medical Enterprises, Inc.
National Medical Fellowships, Inc.
National Mental Health Association
National Multiple Sclerosis Society
National Municipal League/Citizens Forum on Self-Government
National Neighborhood Coalition
National Neighbors, Inc.
National Network of Grantmakers
National Network of Runaway and Youth Services, Inc.
National Park Foundation
National Parks and Conservation Association
National Peace Institute Foundation
National Press Foundation, Inc.
National Psoriasis Foundation
National Public Radio
National Puerto Rican Coalition, Inc.
National Puerto Rican Forum, Inc.
National Retiree Volunteer Center
National School Volunteer Program, Inc.
National Society for Children and Adults with Autism
National Society of Fund Raising Executives
National Society to Prevent Blindness
National Sudden Infant Death Syndrome Foundation, Inc.
National Training and Information Center
National Trust for Historic Preservation
National Urban Coalition
National Urban Fellows, Inc.
National Urban League
National Wildlife Federation
Native American Rights Fund
Nature Conservancy
New Haven Foundation
New World Foundation
New York Community Trust
New York Life Foundation
New York Times Company Foundation, Inc.
Nordson Foundation
Northwest Area Foundation
Northwestern National Life Insurance Company
Jessie Smith Noyes Foundation
OICs of America, Inc.
OPERA America
Oakleaf Foundation
Older Women's League
Open Space Institute
Organization of Chinese American Women
Outward Bound, Inc.
Owens-Illinois, Inc.
PPG Industries, Inc.
Pacific Telesis Group
David and Lucile Packard Foundation
Palm Beach County Community Foundation
Parents Anonymous
J.C. Penney Company, Inc.
People for the American Way
Permanent Charities Committee of the Entertainment Industries

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Pew Charitable Trusts
Pfizer Foundation, Inc.
Phillips Petroleum Foundation, Inc.
Pillsbury Company Foundation
Piton Foundation
Pittsburgh Foundation
Planetary Society
Planned Parenthood Federation of America
Polaroid Foundation, Inc.
Population Council
Population Crisis Committee/Draper Fund
Population Resource Center
Premier Industrial Foundation
Procter and Gamble Fund
The Progressive Corporation
Prudential Foundation
Public Affairs Council
Public Education Fund
Public Service Satellite Consortium
Puerto Rican Legal Defense and Education Fund, Inc.
Quaker Oats Company
Quest National Center
RJR Nabisco, Inc.
RP Foundation Fighting Blindness
Ray Foundation
Raytheon Company
Reader's Digest Foundation
Reading is Fundamental, Inc.
Recording for the Blind
Reinberger Foundation
Charles H. Revson Foundation
Sid W. Richardson Foundation
Rockefeller Brothers Fund
Rockefeller Family Fund
Rockefeller Foundation
Rockwell International Corporation Trust
Rohm and Haas Company
Rosenberg Foundation
Safeco Insurance Companies
Russell Sage Foundation
Saint Paul Companies, Inc.
Saint Paul Foundation
Salvation Army
San Francisco Foundation
Santa Fe Southern Pacific Foundation
Save the Children
Schering-Plough Corporation
Dr. Scholl Foundation
Scientists' Institute for Public Information
Scott Paper Company Foundation
Seaver Institute
Second Harvest
70001 Training and Employment Institute
Shell Companies Foundation Incorporated
Sherwin-Williams Company
Shubert Foundation
Sierra Club
Sierra Foundation
Lois and Samuel Silberman Fund
Melvin Simon & Associates, Inc.
Skidmore, Owings & Merrill Foundation
Skillman Foundation
Alfred P. Sloan Foundation
John Ben Snow Foundation, Inc.
Southern Education Foundation
Southwestern Bell Foundation
Spencer Foundation
Spring Hill Center
Spunk Fund, Inc.
Standard Oil Company (Ohio)
W. Clement & Jessie V. Stone Foundation
Aaron Straus and Lillie Straus Foundation, Inc.
Levi Strauss Foundation

Student Conservation Association, Inc.
Subaru of America Foundation
Sun Company, Inc.
Support Center
Syntex U.S.A., Inc.
TRW, Inc.
Taconic Foundation, Inc.
Tandy Corporation/Radio Shack
Anne Burnett Tandy and Charles D. Tandy Foundation
Teachers Insurance (TIAA-CREF)
Tektronix Foundation
Telecommunications Cooperative Network
Tenneco Inc.
Texaco Philanthropic Foundation Inc.
Theatre Communications Group, Inc.
3M Company
Time Inc.
Transamerica Corporation
Travelers Aid International
Trilateral Commission
Trust for Public Land
USO World Headquarters
Union Carbide Corporation
Union Pacific Foundation
United Board for Christian Higher Education in Asia
United Jewish Appeal
United Negro College Fund
United States Catholic Conference
United States Steel Foundation
United States-China Educational Institute
United Way of America
Upjohn Company
VOLUNTEER - The National Center
Visiting Nurse Associations of America
Volunteer Trustees of Not-For- Profit Hospitals
Volunteers of America, Inc.
WOMENS WAY
Wain Foundation
Izaak Walton League of America
Warner Communications Inc.
Warner-Lambert Charitable Foundation
Washington Center
Washington Post Company
Weingart Foundation
Wells Fargo Foundation
Westinghouse Electric Corporation
Weyerhaeuser Company Foundation
Weyerhaeuser Family Foundation, Inc.
Mrs. Giles Whiting Foundation
Amherst H. Wilder Foundation
Women and Foundations/Corporate Philanthropy
Women in Community Service, Inc.
Women's Action Alliance, Inc.
Women's Equity Action League (WEAL)
Women's Foundation
Robert W. Woodruff Foundation
Woods Charitable Fund, Inc.
World Resources Institute
World Vision
World Wildlife Fund/The Conservation Foundation
Wyman Youth Trust
Xerox Corporation
YMCA of the USA
YWCA of the USA
Youth for Understanding International Exchange
Zale Corporation
Zellerbach Family Fund

Mr. STARK. Thank you. Mr. Hessey.

STATEMENT OF MAHLON W. HESSEY, MEMBER, BOARD OF TRUSTEES, SHRINERS HOSPITALS FOR CRIPPLED CHILDREN

Mr. HESSEY. Yes, Mr. Chairman. My name is Mahlon Hessey. I am a trustee of the Shriners Hospitals for Crippled Children based in Tampa, FL. I have been so for 8 years, and I chair its budget and legislative committee.

The Shriners' hospitals operate 20 hospitals in the United States, commencing with its first unit in Shreveport, LA, some 50 years ago.

It is supported by 850,000 Shriners in North America, and 189 Shrine temples which are located in virtually every one of the 50 States. The immediately preceding speaker, Mr. Brian O'Connell, has eloquently summarized the concerns of all charitable organizations. We adopt those expressions, though Shriners Hospitals is not a member of the organization he represents.

We apparently have done a very bad job in communicating what our Shriners hospitals do. We are a totally free organization. No patient, parent, guardian, Federal or State Government, any political subdivision or any social aid or welfare plan is required to contribute to the support of any patient care at our hospitals, exclusive, of course, of the tax exemptions supplied by Government.

Some people do not believe us when we make that statement, but it is absolutely true. Right in this building, the president of the American Hospital Association was dumbfounded to discover that just a week ago.

We operate, as do all charitable organizations, on donations and endowment income. Our endowment is $2.5 billion. I would like to move down one level and discuss the effect of some of the June 25 Joint Committee proposals on our organization. Sometimes, if you look at them with an overview, it is difficult to estimate what happens at the expenditure level.

If you impose a securities trading excise tax of one-half of 1 percent on the Shriners hospitals, we had $2.4 billion in transactions in 1986, and it would result in the imposition of $12 million in taxes.

Another proposal is a 5-percent Federal income tax on net investment income. Based on our 1986 transactions, we had $136 million in income which would be taxed at $6.8 million; and we had $155 million in capital gains, which would be an additional $7.75 million, for a total of $14.5 million. If added to the $12 million raised as a result of the securities trading excise tax, it would amount to 19.5 percent of our net investment income.

Just what does that $26 million do? The answer is it admits 3,000 patients to our hospitals. So if you impose these taxes, what do we do? Jettison 3,000 children? And what is going to happen to those 3,000 children?

They are either going to move over to other government welfare entitlement programs, since most of them would be entitled to do so, or the Congress is simply going to take the services away from them. They are going to do without.

I would like to comment for a moment on our research program. We operate three burn centers in Galveston, Boston, and Cincinatti. They are 30-bed hospitals. They are small because they are primarily research-oriented, not treatment-oriented.

Twenty years ago there was only one burn center in the United States and that was the Brooke Army Institute in Galveston, TX. Now there are probably 230 burn treatment facilities in the United States, and all of them have built on Shrine technology and research.

All of the early advances in burns care were attributable to Shrine research, and today, one-third of the advances—research results—in burns care is due to the Shrine. The American Burns Institute Association met here in Washington just a few weeks ago, and one-third of the papers presented at that association meeting were produced by Shrine research people.

Twenty years ago, only one-half of the cases where 60 percent of the surface was burned survived. Now, that survival rate is up to 95 percent for such body surface burns. If the patient is burned 95 percent, he has a 50-percent mortality rate today whereas in the past his chances were about 5 percent.

Perhaps we should not spend the money on the care of the 3,000 children. Perhaps we should deduct the taxes you want from those research programs. Let me spend a moment with you about efficiency and cost-effectiveness. According to our estimates, in order to take care of an individual who has suffered 40 percent surface burns, it costs, in a community hospital, between $500,000 and $750,000.

In the Shriners hospitals it costs less than one-third of that due to our specialization and due to the support that we get from other Shrine organizations.

We concur with Congressman Stark's statement on June 26, 1987 before the Oversight Committee, that charitable organizations, including hospitals, should give "an equitable return in exchange for a tax-exempt status".

We submit that we meet that standard better than, and at least equal to, any other hospital organization. We believe that the answer in raising revenues lies in the correction of abuses which may exist, not in the imposition of additional taxes. We urge you to exempt charitable organizations from the legal operations in effect of the securities trading excise tax, and the 5 percent Federal income tax on net investment income because it is counterproductive and it is illusory. Thank you.

[The statement of Mr. Hessey follows:]

Shriners Hospitals
for crippled children
P.O. Box 25356, Tampa, Florida 33622 (813) 885-2575

STATEMENT OF
SHRINERS HOSPITALS FOR CRIPPLED CHILDREN
CONCERNING NEW TAXES ON THE NONPROFIT SECTOR

Committee on Ways and Means Release of
June 25, 1987 (JCS-17-87)

WITNESS:	REPRESENTING:
Mahlon W. Hessey, Esq. Hessey & Hessey 1311 Fidelity Building Baltimore, Maryland 21201	Shriners Hospitals for Crippled Children 2900 Rocky Point Drive Tampa, Florida 33607
301/539-3300	813/885-2575

Mr. Chairman, my name is Mahlon W. Hessey, of Baltimore and I appear today on behalf of Shriners Hospitals for Crippled Children, which operates 20 hospitals throughout the United States. For the past eight years, I have had the privilege of serving as a member of the Board of Trustees of the Hospitals and Chair its Budget Committee and its Committee on Legislation. Our organization is deeply concerned that several staff proposals to raise revenues will do lasting harm to the charitable sector, extract only modest revenues, by government standards, to fund various government programs, and bring to an end a tradition of support and encouragement for charitable services which Government previously enhanced through its tax policies or by direct financial assistance. In my personal opinion, biased perhaps by long years of voluntary service to needy children, taxing the Shriners' free hospital system, or any charitable entity, will not serve the long term interests of our Nation or its economy, will effectively de-stabilize many universities, hospitals and social service agencies, and ultimately jeopardize our country's ability to protect its most precious resource, its children.

Mr. Chairman, our hospitals are absolutely free. No part of costs of the care and treatment of medically indigent children last year, or for any year, were borne directly or indirectly by the patient, his or her parents or guardian, or by the United States, a state or municipality, or any private or public welfare plan. Last year we treated 14,000 orthopedic inpatients, 2,000

burns patients and more than 135,000 outpatient visits were recorded.

The $170 million operating budget for 1988, adopted just two weeks ago (which includes $16 million in research) and the additional estimated $30 million construction budget per year, are derived from donations and earnings on our substantial endowment, now approximating $2.5 billion. Because essentially all new gifts and bequests, and capital gains, are added to endowment, our hospital system is prepared for the deluge of the medical needs of crippled and burned children expected by the year 2000.

Last week we strongly endorsed the Treasury's position that passive investment income spent (or saved) for the public good is in the public interest and should not be taxed. We also emphatically endorsed the concept that charities should not use their tax exemption to acquire, equip, capitalize or subsidize business or commercial enterprises unrelated to the public purpose of the charity. Our research revealed no facts or circumstances, or prospects, for abuse of endowment transactions, since existing law removes almost all exploitation possibilities. Now, however, the staff of the Committee recommends several deplorable tax proposals which could cause our charity, and the children we serve, untold and lasting harm. We are stunned, but not stunned into silence.

Here's how several staff proposals would impact on us:

(1) A securities trading excise tax (STET), would tax sales, exchanges and other non-gift transactions for all forms of securities, including securities in endowments owned by charities, based on the sales price. In 1986, we sold some $2.4 billion in marketable securities in the routine re-investment of endowment assets and we purchased an equivalent amount. The excise tax (rate of .005) on securities' sales would cost us at least $12 million annually based on 1986 transactions.

(2) A five percent federal income tax on net investment income, including interest, dividends and capital gains, is proposed, akin to the two percent tax taxing the investment income of private foundations. In 1986, we earned net income of about $136 million in dividends and interest and realized some $155 million in capital gains. At a .05 rate of tax on this endowment income, an additional $14.5 million in federal tax would be payable, on top of the $12 million STET tax for securities' transactions.

(3) The proposal also includes imposition of an income tax on net appreciation in property passing from a decedent at death, with possible rates being from 28 percent to 33 percent, the income tax rates for 1988. As an alternate, there is a proposal for carryover basis for the appreciated property. The taxation proposal would exempt transfers to a surviving spouse or charity. Although death time transfers of appreciated property to charity are to be exempt, this exemption could always be diluted or repealed, to our detriment.

Of the $150 million in gifts we received in 1986, $120 million were gifts at death. Even if only a fourth of the total value of property bequeathed represented the value of appreciation in these gifts, estates of our donors face a jeopardy of some $9 million to $11 million in income tax (using 28 percent to 33 percent as applicable rates). Since all state tax allocation rules on inheritances impose upon the donee the burden of taxation on bequests, a death time capital gains tax (without a charitable exemption) could cost us upwards of $10 million annually, according to our estimates, and possibly much, much more.

(4) One of the proposals suggests the elimination of the current excise tax exemption for telephone taxes now enjoyed by hospitals and schools. At a 3 percent rate of tax, our tax burden from this repeal would be $33,000 based on the $1.1 million phone bill paid in 1986. If the rate of tax went to ten percent -- which is what it was during World War II, then our costs would increase proportionately.

How do these new taxes impact the operations of our free hospitals? For our orthopedic and spinal cord patients, we estimate our out of pocket expenditures (no amortization of plant or equipment) at about $12,000 per admission; and about $6,000 per admission for burns cases (including reconstructive surgery), or an average of $9,000 or more per inpatient. If we had to pay the federal government $26.5 million in taxes from our operating budget, these taxes can easily be translated into the refusal to admit 3,000 children in need.

In your press release, the Committee asked for suggestions to raise revenues. The nonprofit sector is not above accountability through taxation, since it enjoys numerous privileges and immunities which must be borne by the general population. At our request, Cong. Hal Daub presented a bill to the Congress in 1984 which contained some selective revenue measures -- to balance the revenue costs associated with some charitable contribution incentives we also proposed. In 1986, Congress adopted several of these proposals and we are prepared to think anew with your help about (1) some revenue raising measures which reduce or eliminate abusive situations, (2) balancing revenue needs and social policies, or (3) measures which are keyed to the prevailing desire of the Administration to make users of Government services bear their fair share of incremental costs. We believe this can be done -- but not quickly -- and not without some correlation between the burdens proposed and the value of social services curtailed.

I would be happy to see that any of your questions are answered.

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Mr. STARK. Mr. Pease.

Mr. PEASE. Mr. Chairman, I have no questions. I would just like to thank the witnesses. Mr. Chairman, I think you may have another witness.

Ms. MYERS. Yes, indeed.

Mr. STARK. I beg your pardon.

Ms. MYERS. That is fine.

Mr. STARK. Ms. Myers.

STATEMENT OF ELISSA MATULIS MYERS, CAE, DIRECTOR OF MEMBER SERVICES, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

Ms. MYERS. Thank you, sir. Mr. Chairman, I am Elissa Myers. I am director of member services for the American Society of Association Executives.

ASAE represents 15,000 key executives of major trade and professional associations in the United States. We seek to enhance the professionalism of our members, to improve the performance of the associations they represent, and to help the executives and their associations deal effectively with public policy issues that serve the broad needs of society.

It is with the latter two missions that I am concerned today. Mr. Chairman, ASAE recognizes the important mandate that you have to raise additional revenue. We have great respect for the fine and innovative thinking that went into producing the document listing a wide variety of possible options that you are considering today.

We are concerned in particular with two of the options listed in that document, both designed to tax investment and other passive income of associations, and we are particularly concerned with the impact of those proposals on trade associations and professional societies.

On first analysis, as I have indicated in the full testimony submitted, either measure might appear to generate additional Federal income from trade associations and professional societies of as much as $60 million.

However, it is extremely important, we feel, that you recognize that that apparent income gain is illusory. Taxing the passive income of associations is likely to have one of two equally undesirable effects.

First, associations will be forced to scale back their activities, at least initially, in order to meet the demands of the new tax burden.

Associations are currently and have historically joined their own private-sector initiative to your outstanding efforts to foster the well-being, not only of the association members, but also, of society at large.

The American Association of Advertising Agencies, as a current example, is helping to fight drug abuse. The American Bar Association is helping to educate the public on the unique role of the Constitution.

The National Association of Broadcasters seeks to help displaced workers from declining industries to obtain work skills that will enable them to once again become productive citizens.

More poignant, however, perhaps, than even the large national programs are the countless local efforts that associations engage in to improve society. For example, after a member of the Florida Association of Independent Automobile Dealers noticed a full, unsafe-looking bus being driven in Tallahassee, the association decided to raise funds to purchase a safer bus for the battered and abused children of the Lighthouse Children's Home.

The initial program launched an annual effort which this year built a new education and recreation center for the children.

To the extent that associations are fiscally hampered from carrying on their important work the Nation will suffer. An additional tax on associations is likely to result in a shift in burden from associations back to the Government and represents therefore a false economy.

Second, as Gil Grosvenor from National Geographic stated at the UBIT hearings last week, faced with an increased tax burden, associations will restructure themselves to eventually find a way to continue the important work that they are engaged in.

It is unlikely that they will permanently eliminate one or more of their important activities as a result of the reduced funding.

Rather, in response to that increased expense, it is highly likely that the average association will increase dues or fees to members. Since funding for America's associations comes from for-profit companies and individual professionals, the cost of participating in these associations to the members will increase.

While dues paid to a social club may be discretionary and is often a nondeductible expense, membership in trade associations and professional societies generally represents a necessary business expense, and dues and fees are, therefore, generally deductible. The net effect, then, of taxing association investment income will be to transfer the source of Federal income from corporations to associations, rather than generating additional income.

Further, the tax rate for the associations will often be considerably lower than the average corporate rate. It is probable that the net revenue effect of the two provisions you are considering may be a decline in Federal revenue, while at the same time increasing the expense to the Government of public service.

It should be noted, too, that the outstanding Subcommittee on Oversight of Exempt Organizations concluded its hearings just last week taking a look at the overall tax-exempt environment for associations. It might be an inopportune time to make minor adjustments at this time and might be better to wait until the results of those hearings are finalized.

We recognize, however, the importance of your efforts and believe we can be helpful. We appeal to you to strengthen associations, this most valuable of national resources, rather than further taxing their strength. Please do not diminish the ability of associations to work with you as an important ally by taxing their passive income.

Rather, allow us to add our resources to yours to more fully quantify and understand the unique role of associations in the United States.

Thank you so much for your great courtesy in allowing me time to address you this afternoon.

[The statement of Ms. Myers follows:]

STATEMENT OF ELISSA MATULIS MYERS, CAE

DIRECTOR OF MEMBER SERVICES

AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

BEFORE THE HOUSE WAYS AND MEANS COMMITTEE

HEARINGS ON REVENUE INCREASE OPTIONS FOR FISCAL YEAR 1988

JULY 8, 1987

Mr. Chairman and Distinguished Members of the Committee:

I am Elissa Matulis Myers, CAE, Director of Member Services for the American Society of Association Executives, located in Washington, D.C. ASAE is a not-for-profit tax-exempt society representing the professional interests of 15,000 men and women who serve as key executives of the major trade and professional associations in the United States. ASAE serves three primary purposes. We seek to enhance the professionalism of our association executive members; to improve the performance of the voluntary membership organizations they represent; and to assist these executives and their organizations in dealing effectively with public policy issues that serve the broad needs of society.

It is with the latter two missions that I am concerned today.

Mr. Chairman, ASAE recognizes the important mandate you have to raise additional revenue in order to meet the fiscal demands of our society. We have the greatest respect for the fine and innovative thinking that produced the document describing revenue raising options that you are considering here today.

We are concerned in particular with two of the three options you have proposed that seek to raise funds from exempt organizations. In one provision, it has been suggested that trade association investment income and non-exempt function income including interest, dividends, royalties, rents and other investment income that is currently tax-exempt become taxable as unrelated business income. Second, it has been proposed that investment income of all exempt organizations under Section 501(a) be subject to a 5% excise tax.

We are particularly interested in the impact of those provisions on trade associations, professional societies, and similar organizations represented in the ASAE membership.

We recognize that, on first analysis, it would appear that both of these measures might serve to generate additional federal income. Our research indicates that the 7,500 associations represented by ASAE generate on average 6.4% of their annual income from investments, an average of just over $150,000. That average investment earning, spread over the 7,500 associations represented by ASAE would indicate a potential taxable pool of $1,125,000,000.

A 5% excise tax on that sum would appear to generate an additional $56,250,000 in federal revenue.

However, that income gain <u>is an illusion.</u>

The proposals I have mentioned are likely to have one of two equally undesirable effects.

First, and perhaps of paramount importance, associations will be forced to scale back their activities in order to meet the demands of the new tax burden. The trade and professional associations represented within the ASAE membership are engaged in a vide variety of important activities working to solve both the problems of the nation and the problems of the industries and professions they represent.

They are joining private sector initiative to your outstanding efforts to foster the well being not only of their members but also of society at large.

The American Association of Advertising Agencies, for example, in addition to helping to educate [illegible] its members, also sponsors The Media Advertising Partnership for a Drug Free America -- a 3 that enlists at least $500 million annually of free media time and space to help fundamentally reshape social attitudes about illegal drug use -- to unsell illegal drugs.

The American Bar Association has a wide ranging educational program designed to educate all segments of the American public about the Constitution and its unique role in the nation's history, including an outstanding PBS series that will air this fall, a national mock trial program, and much more.

After a member of the Florida Independent Automobile Dealers Association noticed a full, unsafe looking school bus being driven in Tallahasee, the association decided to raise funds to purchase a safer school bus for the battered and abused children of the Lighthouse Childrens Home. The initial program launched an annual effort that in 1986 marshalled $80,000 in donations for a down payment on a new Education and Recreation Building.

A National Association of Broadcasters program, The Work Resources and Retraining Initiative, is an effort by the NAB and local broadcasters to mobilize community resources to meet the challenge of assisting displaced workers from declining industries to obtain work skills and meet the needs of the technological workplace.

These are just a few examples of the literally tens of thousands of ways that associations and societies are working with you to solve our problems.

To the extent that they are fiscally hampered from carrying on that important work, the nation will suffer. It is even possible that increased government funding will be sought to fill the breach. Or, to put it more simply, an additional tax on the nation's trade and professional associations is likely to result in a shift in burden from associations to the federal government, and represents therefore a false economy. In some cases, those important public services may not be filled at all. In all cases, there will be a time lag, as society restructures to fill the void.

Second, as Gilbert Grosvenor from the National Geographic Society stated at the Unrelated Business Income Tax Hearings last week, recognizing the critical importance of their mandate, associations will restructure themselves in order to find a way to fund their activities. It is highly unlikely that they will permanently eliminate one or more important activities as a result of reduced funding.

Rather, in response to the significant increase in the cost of conducting their good works, the average association will increase dues and or fees to members.

Since funding for the important work of trade and professional associations comes from America's for-profit companies and individual professionals, the cost of participating in the associations to these members will increase.

While dues paid to a purely social or recreational club may be discretionary and is often a non-deductible expense to the taxpayer member, membership in trade associations and professional societies generally represents a necessary business expense or a charitable contribution, and in fact, dues and fees are generally deductible.

The net effect of the two proposed provisions, then, will be to transfer the source of federal revenue dollars from individual and corporate returns to associations rather than generating additional federal dollars.

What we imagine you will also want to consider is that the revenue generated at either the average tax rate under which the association investment income will be taxed or at the proposed 5% excise tax is generally considerably lower than the normal corporate or individual rate.

It is probable that the net revenue effect of the two provisions may in fact have the unexpected and unintended effect of an eventual decline in federal revenue.

It should be noted, too, that a subcommittee of the House Ways and Means Committee just concluded its extensive hearings this past week looking into the tax treatment of exempt organizations in general. It would seem more timely to await the overall recommendations of this important group before making adjustments in this area at this time.

We recognize the importance, however, of your efforts, and believe we can be helpful.

Associations stand ready and able to assist the federal government to more efficiently accomplish many of its programs by bringing to bear the extensive and effective collective membership power they have available. Associations are represented in considerable numbers among those organizations cited by the current Administration for excellence in private sector initiatives.

Many more are actively engaged in such worthy endeavors to serve the broad needs of society, and still more will volunteer to step in where a need can be identified.

America has long sought solutions to its critical problems and emerging opportunities through the collective efforts of its citizens organized into effective association units. We urgently appeal to you to consider once again strengthening this most valuable of national resources, rather than further taxing its strength. Please don't diminish the ability of associations to work with you as an important ally by taxing their passive income.

Thank you for your great courtesy in allowing me time to share my views with you today, and for your outstanding efforts to address the complex national agenda.

Mr. STARK. Thank you.

Mr. Gibbons.

Mr. GIBBONS. I am very familiar with the very fine work that the Shriners do in my area in our hospital there, and we are very pleased with the fine service.

Mr. HESSEY. Thank you, Mr. Gibbons.

Mr. GIBBONS. I look forward to working with you.

Mr. STARK. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I would also like to thank the panel and compliment each of you on the good work that you do in our communities and for our Nation. I am very familiar with all of you, and I am very proud that you are here.

Mr. STARK. Mr. Joseph or Mr. O'Connell, the National Charitable Information Board [NCIB], are you familiar with that?

Mr. JOSEPH. Yes.

Mr. STARK. Are they a reputable organization?

Mr. JOSEPH. Yes.

Mr. STARK. They indicate that a charity should spend no more, I guess, than about 40 percent of its gross income for administration and the cost of fund-raising. Is that a fair figure?

Mr. JOSEPH. Well, my organization deals with grant makers.

Mr. STARK. Mr. O'Connell, could you comment on that?

Mr. O'CONNELL. That is a high figure. It would be justified usually only as an organization was starting up or starting up a new program.

Mr. STARK. It should be lower than that?

Mr. O'CONNELL. I would say most organizations are far, far below that.

Mr. STARK. Okay. Mr. Hessey, you mentioned a $2.5 billion endowment. You mentioned $136 million in income. Is that income from the endowment?

Mr. HESSEY. Yes, sir.

Mr. STARK. That comes up miserably close to 5 percent in my book.

Mr. HESSEY. Well, I am afraid I gave you two different figures. We made 6.41 percent on the investment portfolio. I think it was computed as of 1985. The figure of $2.5 billion I gave to you was 1986. I took 2 different years.

Mr. STARK. I would not try and make a living as an investment adviser on a 6.41 percent figure.

Mr. HESSEY. Well, I apologize. I am glad you picked up that error.

Mr. STARK. Well, I do not know. You guys could just put your money in the bank in long-term CDs and afford to pay us a little tax and still have as much left over and do a little bit more for your country.

Mr. HESSEY. Mr. Stark, I do not know where you got that impression. That is a totally erroneous impression. We transferred $146 million——

Mr. STARK. I am just saying 6.4 percent is a lousy investment performance.

Mr. HESSEY. That is current income. That does not include capital gains, sir. We made $155 million in capital gains.

Mr. STARK. Even without capital gains it is a lousy return. I am just suggesting to you that you could do better.

Now, the Orlando Sentinel found that less than a third of the money raised by the Shrine's 185 temples in 1984 was passed on to the Shrine Hospital charity. They also found that only about 1 percent of the estimated $17.5 million that they received in profits from 175 Shrine circuses went into these hospitals. How do you account for that?

Mr. HESSEY. Sir, first of all, the information is totally incorrect. It begins from an erroneous set of facts and proceeds to an erroneous conclusion.

It fails to distinguish between two entities. One is the Shriners Hospitals for Crippled Children, and if you do the math yourself, you will see we raised between $100 and $125 million in donations during the years in question that were paid directly to the Shriners Hospitals for Crippled Children depending upon the year you are talking about.

Mr. STARK. What about all those social clubs out there?

Mr. HESSEY. They fall under a section 501(c)(10) exemption, and we get a substantial benefit from the activity of those Shriners. They help us with endowment, wills and gifts. Their wives work in our hospitals for nothing.

Mr. STARK. What do they do with all the money they raise? They do not give it to you, do they?

Mr. HESSEY. I wish you would distinguish between the two organizations, Mr. Stark, because you are making the same mistake that the Orlando Sentinel reporters made, which is why it is incorrect. We have to separate the entities involved.

Mr. STARK. Well, then, let us talk about the Better Business Bureau who put you on the do-not-patronize list.

Mr. HESSEY. No, sir, they did not. That is an incorrect statement.

Mr. STARK. What did they do? What did the Better Business Bureau say about the Shrine's fundraising? I will find it here in a minute.

They said you spent too much money on administration.

Mr. HESSEY. They have not put us on a not-approved list. We have submitted all of our financial information to them, and we "understudy" with them. We expect to be qualified by them.

Mr. STARK. It says,

> The National Council of Better Business Bureaus has placed Shriners Hospitals for Crippled Children on a list of charitable groups that failed to meet all of the standards of conduct. The Better Business Bureau said the $2 billion charity, which operates 19 orthopedic and 3 burn centers, did not spend at least 50 percent of its total annual income on charitable programs. Shriners Hospital Charity spent only 33 percent of its $358.4 million income on children's medical care.

That does not sound like a very good record to me. Even the Federal Government does better than that.

Mr. HESSEY. Mr. Stark, those matters are under review with the Better Business Bureau.

Mr. STARK. Let us review them here. Would you think that a charity that only spends 33 percent of its income is doing a good job?

Mr. HESSEY. We spend far more than 33 percent, and I do not know where you got those figures from.

Mr. STARK. I got them from the Better Business Bureau.

Mr. HESSEY. Well, OK. That is because they include capital gains, they include donations, and they include——

Mr. STARK. I would, too.

Mr. HESSEY. Well, OK.

Mr. STARK. What do you do with that money?

Mr. HESSEY. Just let me bring you up to date——

Mr. STARK. Have parties with the capital gains and take the ordinary income and spend that on the kids?

Mr. HESSEY. Let me bring you up to date. We just transferred several months ago $146 million to fund the construction of several new hospitals in the United States, including three new burn institutes. Our burn institutes are technologically obsolete. We have accumulated capital for the purpose of building new hospitals. Many of our hospitals were built at an earlier time, and they are technologically obsolete. They were designed for residual polio patients, and we have under way some $300 million worth of capital programs which we are building as rapidly as we can, given our administrative limitations.

Mr. STARK. Let me not just pick on the Shriners. Hospitals in California do an equally miserable job. The studies that we see on California hospitals show that they spent less than one-fourth in charity what they avoided in taxes. Perhaps I am beating up on the Shriners, but they are perhaps no worse; Jimmy Roosevelt's operation is worse than all of you put together.

But I am suggesting that as these tax exemptions come under review by another subcommittee of this committee that the industry would do well to look at the reasons that they get an exemption. It is not to continue having parties at the Shriners Temple, and it is not to continue the Woodmen of the World or any of the other great fraternal groups that many of us may belong to. It is to replace Government spending. And when you do not do that, you have got to look dangerously like an operation that ought to pay taxes.

I just suggest to you that the Congress is not around picking on people just because we are looking at the do-gooders of the world. We are looking at the folks who have got an awful lot of assets that belong to the American people. Those assets, that endowment does not belong to the Shriners. That belongs to all the American people, and the American people have a right to keep an eye on how well it is invested and how much of it is spent. And if too much of it goes to beer and pretzels and not enough to crippled kids, we are going to come down pretty hard on that. That is true of hospitals or any other do-good, the American Red Cross and all the rest, because some of the associations get to feel it is their money after awhile, and it is not. It belongs to the American people because the people who donated that money were given a major tax exemption to put it in there.

I think that is something you ought to remember.

Mr. O'CONNELL. Mr. Chairman, may I comment?

Mr. STARK. Mr. O'Connell.

Mr. O'CONNELL. I could not agree more on the matter of this being public money, the responsibility of the organizations for absolutely full public disclosure. I do object to what I do not think you

intended, and that is to cite some figures that you feel might apply to one group of hospitals and say that is probably indicative of the way it is with everybody.

I think you would find, Mr. Chairman, that overwhelmingly the public charities of the country are doing what the public hopes they will do in terms of their services to people and communities and causes. I would agree, as I have said within the week to Mr. Pickle's Committee on Oversight, we believe passionately in full disclosure. We believe that we are responsible to the public, and any organizations that do not measure up to that scrutiny should, indeed, achieve the wrath of this committee.

Mr. STARK. Mr. O'Connell, if you are talking about the hospitals, I think I would stand on my statement. Hospitals do a pretty miserable job, and the reason is that the charitable function has been taken over by the Federal Government and the State governments and, in many cases, the county governments. And the old idea that hospitals were charitable institutions is pretty much a way of the past. They are pretty much profitmaking operations.

The shortfall is not made up in the collection plate. The shortfall is made up by taxpayers and by the people who pay for the health insurance. It may be that we ought to make all hospitals taxable and give them a double credit for every nickel they spend on charity, and they would still end up putting an awful lot back in our coffers.

Sometimes institutions change, and I am just suggesting that in the hospital area that is probably the case.

Mr. O'CONNELL. Well, the profile of the income of hospitals has changed greatly over the years with third-party payments representing far more than contributions used to. But, again, I would agree with you that every organization that is a public charity ought to perform public service.

Mr. STARK. You hit it right on the head.

I want to thank the panel very much for their participation, and I will call the next panel: Mr. Braun, who is chairman of the Employee Stock Ownership Association; Mr. Schmidt, who is counsel here on behalf of Robert Georgine, the National Coordinating Committee for Multiemployer Plans; and Mr. Franceski, who is a member of the executive committee of the Bankers Committee for Tax Equality.

Mr. Braun.

STATEMENT OF WARREN L. BRAUN, P.E., CHAIRMAN, EMPLOYEE STOCK OWNERSHIP ASSOCIATION OF AMERICA, AND CHAIRMAN, COMSONICS, INC., HARRISONBURG, VA

Mr. BRAUN. Yes, Mr. Chairman. You have the copy of my formal statement, and that will be for the record.

I would like to make a few informal observations, if I may, sir.

First of all, the ESOP Association opposes the revenue option on pages 124–127 of the joint committee print describing options to increase revenue by repealing the special rule providing for leveraged ESOPs and repealing other rules pertaining to ESOPs.

I would like to give you a personal observation, sir. My company is a 100-percent owned ESOP. It is a leveraged ESOP. It is one

which is highly successful. It is one which has participatory management. It is one which emulates the very best in employee productivity and employee ownership.

I can tell you that was no easy task. This ESOP has been in place since 1974 and, as the growth of the company indicates, quite seriously, sir, the growth rate accelerated quite sharply after the inception of the ESOP and after its implementation together with participatory management.

I can tell you, the clues in that growth curve tell you that this is a very sound way to improve our national productivity. It is one which I have observed personally, one which I have conducted personally—even though today I do not own any stock in the firm, but remain on as the CEO at the request of my employees.

I can tell you that what I have seen is nothing short of a miracle, and I have seen this in more than one company. There are a number of other companies who emulate these same principles: for instance, such as the Katz company in New York City; Fastener Industries in Berea, Ohio; Dalton Foundries in Warsaw, Ind.; Dentsply International in York, PA; Kerotest Manufacturing in Pittsburgh; National Refractories in Oakland, CA; the Mad Butcher in Pine Bluff, AR; the Peoria Star Journal, Peoria, IL; Weirton Steel in Weirton, WV; just to name a few.

Now, what is important is not what appears in the press or the trade journals periodically. It is what happens in firms like ours. Now, sir, there have been many people who have visited our firm, some people interested in the academic aspect of the ESOP concept and how it can be put into the business schools and how it can be taught as a principle leading to successful business operations.

I can tell you that without a single exception, people who have seen our firm have found this to be something exemplary, something worth emulating, and something worth seeing. And I would like to provide you, sir, and the entire committee a special invitation to visit our firm since we are only 135 miles from Washington, D.C. by road. We would like to provide you an opportunity to come and visit and talk with all of the employees.

I can also tell you that our company would not be 100 percent employee owned if it were not for the leveraging. The employees could never have afforded it. The employees could never have made it without the leveraging.

We looked into all sorts of methods prior to putting in the ESOP system to provide for employee ownership since that was my principal purpose that I had in mind in setting up the firm. I wanted the employees to share, and I could find no other good way to do it that would not either penalize the employees or make it impossible for them to pay for it out of earnings. This way, they can and do.

Thank you.

[The statement of Mr. Braun follows. Some exhibits have been retained in the committee files.]

STATEMENT OF MR. WARREN L. BRAUN, P.E.
ON BEHALF OF THE ESOP ASSOCIATION
ON REVENUE INCREASE OPTIONS

July 8, 1987

Mr. Chairman, and members of the House Ways and Means Committee: my name is Warren L. Braun, and I testify today on behalf of the ESOP Association of America, of which I am the chairman. I am also Chairman of ComSonics, Inc. of Harrisonburg, Virginia.

The ESOP Association is a national, non-profit organization with over 1,000 members, of which nearly 70% represent operating corporations with Employee Stock Ownership Plans, or ESOPs. The other members are teachers, students, companies considering ESOPs, and professional men and women who are interested in employee ownership.

The ESOP Association opposes vigorously the revenue option proposal on pages 124 through 127 of the revenue options booklet that would eliminate all leveraged ESOP companies.

What are leveraged ESOPs?

Well, my company, ComSonics, is a leveraged ESOP, and it is 100% employee owned.

There are approximately 1,500 leveraged ESOP companies in the United States. Many of these companies belong to the ESOP Association, and hold leadership positions in the Association. These companies, their managers and employees are in the forefront of the growing movement toward meaningful employee ownership of capital.

Allow me to list a few examples:

- o Katz Communications, New York City
- o Fastener Industries, Berea, Ohio
- o Dalton Foundries, Inc., Warsaw, Indiana
- o Dentsply International, York, Pennsylvania
- o Kerotest Manufacturing, Pittsburg, PA
- o National Refractories, Oakland, California
- o The Mad Butcher, Pine Bluff, Arkansas
- o The Peoria Star Journal, Peoria, Ilinois
- o Weirton Steel, Weirton, West Virginia;

and I could go on. Mr. Chairman, attached to my statement are profiles of several leveraged ESOP companies. I know that your rules will not permit these profiles to be printed as part of the permanent record, but we want you, your colleagues and staff to have these profiles.

But, Mr. Chairman, permit me to tell about the leveraged ESOP company that I know best, ComSonics.

ComSonics started in 1972. And like any new business flamed by the spirit of free enterprise, we were optimistic; but, bluntly times were hard.

Then we began our employee ownership program in 1975. The employee ownership share has grown and grown, through the leveraged ESOP until ComSonics became 100% employee

owned. Since 1975, we have grown 1240%, and INC. magazine has selected us as one of the fastest growing companies in America.

Why have we grown and prospered? Why has the United States Senate given ComSonics a productivity award? Why do researchers and their students come to ComSonics to study why we are what we are?

Because of employee ownership, and the corporate culture that surrounds worker-owners, who are part of a "team" effort to work productively and harmoniously.

Not only are we productive, we create jobs. In 1975, we had 29 employees. Today we have 162 employees.

And how has Uncle Sam's revenues done since we became a leveraged ESOP company? I am happy to report that ComSonics has enhanced Federal revenues since 1975. In 1975, we paid less than $6,000 in Federal taxes. This fiscal year, we will pay $118,000 in Federal taxes even with over $200,000 in ESOP payments, and over $350,000 in research and development. We are pleased to pay, as employee owners, our fair share of corporate taxes. We intend to do more in the years ahead.

Mr. Chairman, every leveraged ESOP company is unique, but there is a growing body of evidence that ESOPs in a healthy company bring about new heights of productivity. We cite and call to your attention the White House Conference on Productivity, the President's Commission on Industrial Competitiveness, a New York Stock Exchange study, a study by the Atlanta Federal Reserve Board, the report of the Presidential Task Force on Project Economic Justice, Corey Rosen's book, Employee Ownership in America - The Equity Solution, and I could go on and on. A list of such studies is attached.

Mr. Chairman, we do not understand why any one would consider snuffing out significant employee ownership as proposed in the revenue options booklet.

First, Mr. Chairman, during the tax reform deliberations, neither Treasury I or II, or Rostenkowski I, or the final House Ways and Means ESOP provisions, would have repealed leveraged ESOPs. It was never even considered.

You recall that the Ways and Means position was developed after hearings by the Oversight Subcommittee that included a review of ESOPs role in merger and acquisitions (and I may add, the Subcomittee found very little role for ESOPs), a joint Oversight-Social Security Subcommittee hearing on ESOPs as retirement plans, and of course the full Committee hearings on special tax provisions pertaining to ESOPs during the tax reform deliberations.

The result of your study was ESOP provisions in your tax reform bill that included several new ESOP rules. Some of us in the ESOP world may feel that your ESOP reforms were too harsh, or too restrictive; but the fact is that you and your committee, and your staff, developed these new rules, and insisted on them in conference with the Senate. You did so because you believed the new rules - on valuation, on voting rights, on diversification, on distributions - would make ESOPs work better.

We believe that these new rules were reasonable and well-conceived responses to the real-world operations of leveraged ESOPs.

On the other hand, the proposal to eliminate ESOPs as in the revenue options booklet is not reasonable. It would not even raise significant revenues, because bluntly, and we believe unfortunately, there are very few employee owned corporations in America.

The proposal, and many people may not realize this, would repeal legal positions recognizing leveraged ESOPs that date back to the late 1950's, when the IRS sanctioned the first leveraged ESOP, although it was not called an ESOP back then.

And, Mr. Chairman, it is a myth that leveraged ESOPs are used only to ward off hostile takeovers. The truth is that recent court decisions and informal positions by the Department of Labor, may make the employees' stock the most vulnerable to a tender offer, controlled neither by management nor the employees, but by the price offered by the corporate raider. We, the ESOP Association, are working with the Senate Labor Committee, and the Senate Banking Committee, to clarify the current confused situation, and to give employees a voice in the face of a tender offer.

Mr. Chairman, it is a myth that leveraged ESOPs are used only to dump "sick" companies on innocent employees. Of the approximately 1,500 leveraged ESOPs, around 100 were so-called "distressed" buyouts, according to the National Center for Employee Ownership. These ESOPs saved over 75,000 jobs that would have been otherwise eliminated. In nearly all of these buyouts, representatives of a bargaining unit initiated the buyout, not management.

Your Joint Committee revenue estimates prove leveraged ESOPs are not being created willy-nilly, Mr. Chairman. Setting up an ESOP is complex, and those involved had better be very careful. Anytime the ESOP is not treated fairly, as any third-party investor, the Department of Labor is likely to stop the transaction dead in its tracks, or if it slips through, bring legal action against the erring fiduciaries.

In fact, we are presently working with Secretary Brock's ERISA Advisory Committee's Work Group on ESOPs to improve DOL's enforcement of ESOP laws. The work group has tentatively decided to encourage ESOPs in buyouts - just the opposite of what is proposed to your committee by someone. It does so because it feels the Department may have, unintentionally, stopped nearly all leveraged ESOPs in multiple investor situations.

In short, Mr. Chairman and members of the Committee, there is no evidence that leveraged ESOPs, and the significant ownership they provide, compared to stock bonus plans, or the so-called non-leveraged ESOP, are draining the U.S. Treasury, or are set up without any oversight by Federal regulators.

Finally, Mr. Chairman, we recognize that you have a difficult task - to pass a $19 billion tax bill for 1988, and $65 billion for three years. The revenue options booklet proposes to obtain less than one half of one percent of that money by eliminating leveraged ESOPs.

We of the ESOP Association have always argued that we spoke for the "skinny" cats, and not the "fat" cats. We recommend you give strong consideration to the ESOP Association's traditional position that tax increases should be progressive and from a broad base. We believe in the income tax system, but also know broad based consumption taxes may be fair.

But whatever you do, please do not go after the employees, who just want to become more than a "skinny" cat.

I would be pleased to answer any of your questions.

EMPLOYEE OWNERSHIP AND CORPORATE PERFORMANCE

The studies listed below are only some of those showing that employee ownership has significant and very positive implications for corporate performance.

1. ***1986 National Center for Employee Ownership (NCEO) study*** established the first definitive causal link between employee ownership and improved corporate performance. The ESOP companies had sales growth 5.40% faster than their competitors after their plans versus 1.89% per year before. The ESOP companies had employment growth 5.05% per year faster than their competitors after establishing their ESOP, versus 1.21% before their ESOPs. Both statistics have at least a 95% confi dence level (i.e., there is only a 5% probability that the dif ference could be due to chance). Because the study analyzed ESOP companies performance vis-a-vis their competitors for several years both before and after their ESOPs were installed, it is certain that most of the superior performance of ESOP companies is due to ESOPs, not due to the fact that better performing companies are more likely tc set up ESOPs (although that seems to be true also).

The study also found that companies which combined ownership with job-level participation programs did even better than companies which simply started an ownership plan. The most participative companies improved their performance by about 8-11% on various measures of growth as compared to their pre-ESOP performance, versus about 3.5% for the least participative.

2. ***Employee Ownership in America: The Equity Solution***, results of a four-year study by the NCEO of 37 ESOP companies found that the most important factor associated with positive employee attitudes toward ownership was a large annual contribution to the ESOP plan. Other important factors included management's attitude toward employee ownership and job-level participation opportunities. This study measured employee attitudes, but did not measure corporate performance directly.

3. ***1985 ESOP Association survey*** of 239 member companies found that 16% of the companies believed ESOPs had "strongly improved" their productivity, while 56% believed that employee motivation and productivity had "somewhat improved".

4. ***1984 University of Michigan study*** of 115 employee owned companies found that these companies performed at roughly the same level as similar conventional companies during the 1976-1982 period, but were 10% more likely to stay in business.

5. ***1984 NCEO study for the New York Stock Exchange*** of thirteen companies that were 10% or more employee owned found that these firms outperformed 62-75% of their competitors, depending on the measure used (net operating margin, return to equity, sales growth and book value per share).

6. ***The 100 Best Companies to Work For***, 1984, found that sharing ownership was one of the characteristics of desirable employers, and listed eight substantially employee owned companies among the top 100.

7. ***1984 Savvy magazine survey*** of the best companies for women to work for added nine companies to their list, five of which were substantially employee owned.

8. ***1984 McKinsey and Company study***, "The Winning Performance of Mid-Sized Growth Companies" found that these successful firms tended to share ownership with employees to a greater degree than larger firms.

9. ***1984 Atlanta Federal Reserve study*** of 22 premier companies in the South—employee ownership a common thread.

10. ***1983 NCEO study*** found that employee owned companies with a majority of their stock owned by employees generated 3 times as many net new jobs per year as non-ESOP firms.

11. ***1980 study reported in the Journal of Corporation Law*** found that companies with ESOPs had twice the annual productivity growth rate of comparable conventional firms during the 1975-79 study period.

12. ***1978 University of Michigan Survey Research Center study*** found that in a sample of 30 employee ownership companies, profits were 1.5 times as high as those in comparable conventional firms.

Mr. STARK. Thank you.
Mr. Schmidt.

STATEMENT OF K. PETER SCHMIDT, COUNSEL, ON BEHALF OF ROBERT A. GEORGINE, CHAIRMAN, NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

Mr. SCHMIDT. My name is Peter Schmidt. I am a partner in the Washington law firm of Arnold & Porter. I am testifying today on behalf of Robert A. Georgine, the chairman of the National Coordinating Committee for Multiemployer Plans.

Mr. Chairman, the NCCMP and its affiliates are deeply concerned about the recent misguided legislative trend towards cutting tax incentives for essential employee benefits in an effort to reduce budget deficits. We, too, are deeply concerned about the Federal deficit problems. As we have noted before, however, the budget cannot be balanced on the backs of our sick, our elderly, and our working poor. The existing protections and incentives for essential employee benefit programs must be preserved.

Congress has recently shown an inclination to deal with these essential programs in the name of tax reform or deficit reduction on an ad hoc, piecemeal basis. Continuation of this trend will produce not only an irrational crazy quilt of rules, but also the step-by-step destruction of our Nation's carefully conceived employee benefits structure.

As to attacking budget deficits in this manner, our views are simple: Reducing or eliminating the tax incentives for important employee benefit programs—programs that are essential to the health and security of working Americans—is fundamentally wrong. It would also be counterproductive in the long run since expensive new Government programs would likely be required if these private sector programs were to dry up.

For these reasons, the NCCMP and its affiliates strongly oppose any excise tax on the net investment income of employee benefit trusts. Such a tax would produce either increased employer costs or reduced benefits, and make it more difficult for employee representatives to bargain successfully for such plans. As a result, millions of working Americans and their families—not to mention retirees, laid off workers and their families—could be deprived of the basic retirement, health, death and other welfare benefits necessary to their physical well-being and financial security.

We also strongly urge you to reject any tax on employer paid health care benefits, whether structured as a cap or as a floor. Regardless of its form, a tax on health care benefits would likely destroy many private health care programs.

In collectively bargained plans, the decision to begin or continue health benefit programs is made for a group rather than for each individual. If increased tax burdens make health benefits more expensive, the younger and healthier workers who think they will never need care could well ask their bargaining representative to support the termination of health benefit programs. These workers' first priority is their most immediate needs: housing, food and clothing. Many have little or no discretionary income with which to purchase taxable health care benefits. Faced with the alterna-

tives of reduced wages or elimination of taxable health benefit programs, many younger workers will choose the latter.

On the other hand, older workers and workers with health problems are only too aware of the need for employee paid health coverage. If group programs are eliminated, some of these workers may be uninsurable on an individual basis, or insurable only at prohibitive rates. If good health benefits are not provided by the private sector, these workers will be forced, through no choice of their own, to fall back on Government programs.

Both the cap and the floor would fall harshly across a broad cross-section of multiemployer plan participants. Lower paid workers would be among those adversely affected by a cap since high health coverage costs in multiemployer plans are not necessarily linked to high income levels for covered employees. The cap would also discriminate against those living in high cost areas where the same basic coverage is more expensive than elsewhere, as well as older groups, groups with retiree coverage, groups in declining industries, and groups that provide extended coverage to unemployed workers' families.

The proposed tax floor also discriminates by taxing everyone on the same flat dollar amount regardless of income or the character of coverage. Three hundred dollars in additional taxable income will obviously be tougher on a low wage earner and will represent a bigger piece of the less comprehensive benefit package that is typical in low wage industries.

One of our greatest concerns is that any tax on these essential benefits could easily prove to be the proverbial camel's nose under the tent. It would be all too easy to increase any floor in future years where revenues are desperately needed. Similarly, any health care cap could be lowered. In any event, a cap-type tax would increase automatically unless the cap were indexed to fully reflect increased costs.

A repeal of the current exclusion for group term life insurance would also cause younger, healthier and lower income workers to bail out of those plans leading to their destruction. Older workers and workers with health problems who may be uninsurable on an individual basis or insurable only at prohibitive rates would be left without life insurance coverage. In many cases, through no fault of their own, the widows and children of such workers would be forced to rely on Government programs.

We have included discussions of other important issues in our written testimony. Thank you very much.

[The statement of Mr. Georgine follows:]

National Coordinating Committee for Multiemployer Plans

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July 8, 1987

TESTIMONY OF ROBERT A. GEORGINE, CHAIRMAN
NATIONAL COORDINATING COMMITTEE FOR
MULTIEMPLOYER PLANS

BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
ON REVENUE INCREASE OPTIONS

1. Introduction. My name is Robert A. Georgine, and I am submitting this testimony in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee was organized, shortly after the passage of ERISA in 1974, to represent the interests of the more than eight million working men and women, and their families, who are covered by multiemployer plans. The Committee's affiliates include more than 170 pension funds, health and welfare funds, and related international unions.

The NCCMP and its affiliates are deeply concerned by the recent legislative trend toward (1) proposing elimination of tax incentives for essential employee benefit programs under the misnomer of "tax reform"; and (2) attacking federal budget deficits through the imposition of additional tax burdens on these essential programs. These crucial programs will be destroyed if this trend continues. We are thus alarmed and dismayed at the Description of Possible Options to Increase Revenues, Prepared for the Committee on Ways and Means by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means ("Description") which includes suggestions that could have an extremely harsh impact on employee benefit plans.

The benefits provided today through collective bargaining or pursuant to federal or state legislation are the hard-won product of years of struggle. These benefits are essential to the financial security and physical well-being of working men and women and their families, who could not otherwise afford them. They provide essential protection against illness, forced early retirement, unemployment, and other tragedies or contingencies that interrupt earning power. They provide income that permits retirees to live with dignity, and without burdensome dependence on the public sector.

Congress has long recognized the importance of these programs, and, through favorable tax treatment, has encouraged their growth and development. These modest tax incentives have resulted in the provision of essential benefits to a broad cross-section of employees, especially lower-paid workers. More than seventy-five percent of those accruing pension benefits in 1983 earned less than $20,000 per year. Eighty percent of those with employer-paid health insurance in 1985 earned less than $25,000 per year. Health insurance was then being provided to nearly 80 percent of all public and private workers, and term life insurance coverage was virtually universal. Thus, the vast majority of employee benefit recipients are lower and middle-income individuals, who rely on their employer-paid benefits for their own and their family's security.

Unfortunately, Congress has recently shown an inclination to deal with these essential programs on an ad hoc, piecemeal basis in the context of deficit reduction or so-called "tax reform." Continuation of this trend will produce not only an irrational crazy quilt of rules, but also the step-by-step destruction of our nation's carefully conceived employee benefits structure. We can't just keep piling complicated rule on top of complicated rule or adding bits and pieces of new taxation without careful consideration of the impact on employee benefits policy and goals.

Elimination of tax incentives for essential employee benefit programs does not constitute the closing of any "loophole," and does not serve any of the other goals generally advocated as "tax reform." Moreover, attempting to balance the federal budget by reducing or eliminating the favorable tax treatment supporting essential employee benefit programs so important to the physical and financial well-being of working Americans is fundamentally wrong. Employees who rely most heavily on essential employee benefit programs are those least able to afford increased tax burdens. What kind of country is it that proposes to balance the budget on the backs of our sick, our elderly and our working poor?

Taxing essential employee benefit programs is also counterproductive in the long run because federal budget deficits will actually be increased by the need to fund new and expanded government programs to replace private sector programs. These programs provide benefits that would otherwise have to be provided through government programs like Medicare, Social Security and federal and state unemployment. Subjecting these essential benefits to FICA and FUTA tax -- regressive taxes that fall most harshly on the lower-paid workers who rely most heavily on employee benefit programs would be even less defensible.

In our view, the correct course is simple: No additional taxes on essential employee benefit programs.

2. Excise Tax on Net Investment Income of Exempt Organizations. Particularly ill-advised would be adoption of the Description's revenue-raising suggestion for imposition of a five percent excise tax on the net investment income of all tax-exempt organizations, including employee welfare benefit trusts and pension and profit sharing trusts. We strongly urge you to reject this as a method of raising revenues.

Any tax on the income of employee welfare and pension funds will increase the cost to employers of providing these benefits and make it even more difficult for employee representatives to bargain for adequate health and welfare and retirement benefits. As discussed at length above, and as recognized in the Description, these organizations provide essential benefits that lessen the burdens of government and that otherwise would have to be financed out of tax revenues. Thus, their decline or destruction, due to short-sighted imposition of additional tax burdens, would not only deprive millions of working Americans and their families of vital benefits, but, in the long run, would actually increase budget deficits.

We note in this regard that if plans are taxed and continue to provide current benefit levels, employers would have to increase contributions to cover

amounts plans pay as taxes. Since these additional contributions will themselves be tax deductible, even the short-term net revenue increase would be reduced by a percentage equal to the employer's tax bracket -- i.e., approximately one-third.

We also note that the Internal Revenue Code already insures that employers cannot intentionally make tax deductible contributions to fund pension plans beyond what is required to provide promised pension benefits. Where inadvertent actuarial error produces a surplus, any reversion to the employer is subject to an excise tax under current law, and, in fact, no reversion at all is allowed from a multiemployer plan. The Deficit Reduction Act of 1984 established complex rules imposing unrelated business taxable income tax on the reserves of welfare benefit plans to assure no potential for abusive prefunding and imposing a 100% tax on any assets reverting to the employer. Thus, employee welfare and pension benefit trusts are in a much different posture from certain other types of tax-exempt organizations, such as 501(c)(3) organizations, most of which are not generally subject to explicit contribution or reserve restrictions. Accordingly, if any tax were to be imposed on the net income of tax-exempt organizations, an exception should be provided for all employee benefit trusts.

3. Tax on Employer-Paid Health Care Benefits. The NCCMP and its affiliates are strongly opposed to any tax on employer-paid health care benefits, whether structured as a "cap," as a "floor," or otherwise.

If the direct cost of health insurance benefits increased from greater tax burdens, regardless of form, many younger and healthier workers, who feel least in need of such benefits, would likely drop out of plans. This also would be true of low-income workers who simply cannot afford the additional cost. As their participation ended, the cost for the remaining workers would increase and could eventually become prohibitive. Alternatively, the remaining workers might not be a sufficient percentage of the workforce to pass new nondiscrimination tests after 1989. The end result would likely be the destruction of many such plans. Even before this, a health care cap would prompt the elimination of such protections as preventive, dental, mental health, vision care, prescription drug plans, diagnostic programs and out-patient services.

This devastation would come about even more quickly in collectively bargained plans. In such plans, workers cannot opt out individually. The decision not to bargain for such benefits is made by the collective bargaining representative for the group. Thus, the younger workers may likely vote to terminate health benefit programs. These young workers are faced with tough economic choices. Their first priority will necessarily be to satisfy their most immediate perceived needs like housing, food, transportation, and utilities. Many of these workers, especially the lower paid workers, have little or no discretionary funds they can choose to allocate to a tax on health care benefits, let alone to the cost of the benefits themselves. This is particularly true in the current economic climate, when many employers are reducing wage packages. Faced with the alternative of accepting further reduced wages or eliminating taxable health benefit programs, many younger workers will feel that they simply cannot afford

to pay for taxable health benefits they do not expect to need in the near future.

As a result, older workers and workers with health problems may lose the opportunity to obtain health care coverage through employer paid programs. The cost of providing medical benefits increases dramatically with increased age of covered workers. For example, the cost of providing medical benefits to workers age 44 and under is only 80% of the average cost of providing benefits to all employees. This percentage increases with age to 112.5% for employees age 50 to 54, 125% for employees age 55 to 59, and 160% for employees age 60 to 64. Thus, many of these workers will be uninsurable on an individual basis or will find it impossible to obtain health insurance coverage at affordable rates. Through no choice of their own, they will be forced to rely on government programs. And just as important, the different goals and needs of older versus younger workers are likely to put additional strains on collective bargaining if the government forces workers to make these choices. Those strains will make it more difficult for collectively bargained plans to obtain the funding they need to provide benefits which would otherwise be unavailable.

Without new or expanded government programs, families stricken by illness could be left with no means of obtaining basic health care. Private sector programs provide over $80 billion per year in essential health protection, for a tax expenditure of only about $18 billion. Without these private sector programs, the government could well be required to spend all of that $80 billion directly.

Both the "cap" and the "floor" would fall harshly on a broad cross-section of multiemployer plan participants. Several years ago, a national actuarial consulting firm conducted a study of the 494 multiemployer welfare plans on which it has complete data. That study estimated that nearly half of the 1.4 million participants in those plans would have had to pay additional tax, averaging more than $150, if a tax cap on coverage exceeding $175 per month for a family or $70 per month for an individual had been effective in 1984. The study projects that, by 1989, almost 375 -- over three-fourths -- of such plans, covering more than one million employees, would be over the "cap."

Lower-paid workers would be among those adversely affected by such a "cap." High health coverage costs in multiemployer plans are not necessarily linked to high income levels for covered employees. Low-paid workers are often covered by multiemployer health plans that provide them a comprehensive benefit safety-net. Per-employee costs may be high in a multiemployer plan, because the plans generally cover dependents, and many make benefits available for those working only erratically in the industry or actually laid off, for whom claims may be high and no contributions are being made.

Under the "cap," a participant's additional taxable income would be a function of the amount by which the cost of his benefit coverage exceeded the "cap." Those with benefit coverage far in excess of the "cap" would pay much more than those who exceeded the "cap" only slightly. Thus, in addition to hitting those with "comprehensive" coverage, the "cap" would discriminate against those living in high-cost areas

where the same basic coverage is more expensive, as well as older groups, groups with retiree coverage, groups in declining industries, those that provide extended coverage to unemployed workers and their families, and others.

On the other hand, a tax "floor" of $25 per month for family coverage and $10 per month for individual coverage would likely affect all multiemployer plan participants. Thus, each participant with a family would have $300 in additional taxable income every year -- $120 per year for participants with individual coverage. The resulting individual tax liabilities would depend on the participant's tax bracket.

As with the "cap," there are problems of relative equity in taxing everyone on the same flat dollar amount of their employer-paid coverage. For example, $300 in additional taxable income might be considered more onerous for a low-wage earner, and would represent a larger percentage of the total benefits provided to those with less comprehensive benefit packages.

Both the "cap" and the "floor" would be particularly burdensome for retirees, unemployed people, surviving spouses and dependents, and others with extended coverage under an employer-paid plan. These people might have little other income from which to pay the tax, but it would hardly be fair to include the cost of retiree and other extended-coverage benefits in the costs on which active workers taxes are based.

We also note that some states require insured health plans to provide certain types of health benefit coverage and that federal legislation currently being considered by Congress would require most employers to provide health benefits to their employees. It would be unjust to require employees to have this coverage whether they want it or not and then tax them on any portion of the value of it.

The burdens for multiemployer plans in complying with a health care tax would be imposing. If withholding were required, it would likely have to be done by contributing employers. The plans themselves do not pay cash health benefits to participants from which they could withhold.

The contributing employers would not know enough about the participants' benefit eligibility and coverage to do withholding, and the paperwork necessary to give them this information would be overwhelming. Many employers know little more than the hourly rate at which they contribute to a multiemployer plan. They wouldn't know which of the employees actually have plan coverage, or what their benefits are. Plans would have to send each of their hundreds or thousands of employers weekly printouts showing a current list of covered employees, whether such employees have individual or family coverage, and the value of that coverage. This is an extraordinary amount of paperwork in light of the large number of employers contributing to multiemployer plans and the generally small size of contributing employers.

We assume that no one would seriously propose taxing employees on contributions without regard to whether the employees are eligible for plan coverage. In many cases, employer contributions are measured by the hours worked by all bargaining unit employees, with a minimum amount of covered work required for an

employee to gain and keep eligibility. Thus, someone for whom a contribution is made would not necessarily have health coverage that could be called "income."

Moreover, many plans don't know that particular employees have satisfied eligibility requirements until several months after eligibility is attained. Plans have to wait until they receive monthly or quarterly contribution reports from employers, and analyze the data. Indeed, in some industries, there are so many casual workers that plans ordinarily don't make a determination with respect to eligibility until a claim is actually made.

Most multiemployer plans of any significant size either have experience-rated insurance contracts or are self-insured. In both cases, the plans don't know what the cost of health coverage for a particular year is until substantially after the end of that year. It would therefore be impossible for most multiemployer plans to provide up-to-date data on a weekly basis, making withholding by the employer very difficult, if not impossible.

The plan itself cannot substitute for the employers for withholding purposes, because it would not make cash payments to participants from which taxes could be withheld. These withholding burdens would be much worse for Social Security (FICA) and federal unemployment taxes (FUTA), because the applicability of these taxes depends on the total amount of income the employee has earned during the year -- information plans ordinarily do not have. This would be an even worse nightmare for FUTA tax which must be coordinated not only with amounts that have already been paid by employers, but also with multiple state offsets applicable in the various states in which a multiemployer plan operates.

An alternative to withholding would be to have employees compute and pay the tax at the end of the year However, this raises serious questions of equity, especially for lower-paid workers who may find it extremely difficult, if not impossible, to come up with money sufficient to pay the tax all at once at the end of the year.

Finally, both the tax "cap" and the tax "floor" could easily prove to be the proverbial camel's nose under the tent. If a tax "floor" were enacted, it would be easy to increase the "floor" in future years until the entire amount of all employer-paid health care coverage were taxed. Similarly, a health care "cap" could be lowered in future years. A larger percentage would be covered in any event unless the "cap" were raised each year to reflect increased coverage costs. (We have similar concerns with respect to any proposal to tax a flat percentage of every exempt organization's income.)

In short, we believe that taxing health care benefits would be unfair and largely unworkable under any type of proposal. These benefits serve crucial social purposes. Without them, there would be increased pressure for new and expanded government programs which would cost far more than the revenue collected through the taxation of private sector benefits. Thus, these essential benefits should continue to be encouraged, as they have in the past, through favorable tax treatment.

4. Repeal of Exclusion for Employer-Paid Group Term Life Insurance. The Description raises the possibility of repealing the current exclusion from employee income of up to $50,000 of employer-paid group term life insurance. We urge you to reject this possibility.

Employer-paid group term life insurance is essential to the financial security of millions of ordinary working people and their families, who could not otherwise afford such protection. These benefits protect dependents against financial deprivation resulting from a loss of income at the time of an employee's premature death. Term life insurance is provided by employers to most public and private workers. The vast majority of its recipients are lower- and middle-income individuals, who have planned their futures and their family's security based on this vital benefit.

The private sector employee life insurance program, like other essential employee benefits, is a good buy in terms of tax expenditures. Its destruction, which could result from curtailment of its favorable tax treatment, would create serious deprivation for workers and their families and would likely impose substantial additional pressures on federally funded or assisted welfare and other programs. Without assistance through new or expanded government programs, families stricken by the death of a breadwinner would be left with no means of obtaining basic necessities. Any short-term deficit reduction brought about by curtailment of the existing benefit program structure could thus be outweighed by the resulting, long-term demands for direct government expenditures.

In addition, the administrative burdens would be enormous, especially for multiemployer plans. Under current law, the cost of life insurance in excess of $50,000 is calculated under uniform tables prescribed by the IRS. Use of these tables requires knowledge of the age of an employee and the number of months during the year he worked. Because this would be virtually impossible for multiemployer plans, which generally do not have the necessary information, such plans provide benefits below the $50,000 exclusion limit. If all such insurance were subject to inclusion, plans could presumably have to provide this data to all participants. Further, such plans would have to send W-2's, which they do not now provide, to each employee at the end of the year. Especially for younger workers, the administrative costs involved could well exceed the tax on the benefit.

We also want to point out that the life insurance exclusion is as important to thousands of self-insured plans as it is to insured arrangements. For many years, collectively bargained employee welfare benefit plans have provided death benefits to participants and their beneficiaries through tax-exempt trusts. These trusts have historically been operated and financed in a manner comparable to group term life insurance arrangements. Death benefits paid from such trusts have been regarded as excludable under Code section 101(a) from a recipient's income as amounts received under a life insurance contract. Ross v. Odom, 401 F.2d 464 (5th cir. 1968) Cf. Private Letter Ruling 7206209210A (June 20, 1972). This makes sense since, like life insurance contracts, these programs are formal, binding,

and actuarially designed to provide the promised benefits.

5. Repeal of $5,000 Death Benefit Exclusion. We also urge you not to repeal the $5,000 death benefit exclusion. This is an extremely vital benefit which is necessary to assist the families of working Americans that are stricken by the loss of a breadwinner. This modest $5,000 amount is not enough to do more than provide funeral costs and basic sustenance temporarily while a family tries to make other arrangements for its support. It would be unconscionable to tax these modest amounts which are intended to tide over families trying to deal with a sudden financial crisis in a time of grief.

We note that this exclusion may be important to some self-funded welfare plans, as well as to unfunded, uninsured arrangements. There may be self-funded welfare plan arrangements that fail the Ross v. Odoms test described above because they are not operated and financed in a manner comparable to group term life insurance arrangements. Participants in these plans would also be hurt by a repeal of the exclusion.

On the other hand, the vast majority of self-funded death benefit plans satisfy the Ross v. Odoms test. These plans could be protected by retaining the life insurance exclusion discussed above.

If the death benefit exclusion were nonetheless repealed, legislative history must ensure the continued availability of the life insurance exclusion for plans satisfying the Ross v. Odoms test. We suggest that the following language be included in all reports on the provision:

> "The repeal of the $5,000 exclusion for employer-paid death benefits is not intended to restrict in any way the current exclusion as insurance proceeds available for death benefits paid from self-funded employer-paid welfare benefit plans. The Committee intends that death benefits paid to employees through a funded employee welfare benefit trust 'should continue to be regarded' as paid pursuant to a life insurance contract where the trust is operated and financed in a manner comparable to group term life insurance arrangements, under the principles of Ross v. Odom, 401 F.2d 464 (5th Cir. 1968)."

6. Securities Transfer Excise Tax. The Description raises as a possible revenue raising option a securities transfer excise tax of 0.5 or 1.0 percent of value upon transfers of securities. As the Description notes, this would be a regressive tax to the extent it applies to employee pension and welfare benefit plans because a significant amount of wealth is invested by these plans on behalf of lower and middle income individuals. In addition, it would increase the costs to employers of funding these essential benefits, thus making it more difficult for employee representatives to bargain successfully for the basic benefits vital to the physical well-being and financial security of working Americans and their families. Any revenue increase obtained in this fashion would also be

offset to some extent by the increased deductions for the increased employer contributions necessary to make up for the tax loss to the trusts.

7. Treatment of Loans from Qualified Plans as Distributions. The Description suggests treating all loans from qualified plans to participants as taxable distributions, except to the extent they represent a return of the employees' investment in the contract. This would have the practical effect of eliminating participant loans, as employees would have to pay tax on the amount borrowed (including, presumably, an extra 10% if the borrower is under 59½) and still pay the full amount back to the plan. Many multiemployer defined contribution plans have traditionally allowed employees to borrow from their own accounts. If that were not allowed, employee support for those plans would be weakened, perhaps to the point of curtailing or eliminating them. This would undercut the retirement security of all workers for whom these plans represent a needed supplement to their basic pensions.

In addition, certain types of participant loans should continue to be excluded from the loan/distribution concept.

The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") introduced the rules treating certain loans from retirement plans as taxable distributions. The Conference Report on TEFRA provides that:

> Investments (including investments in residential mortgages), which are made in the ordinary course of an investment program will not be considered as loans, if the amount of the mortgage loan does not exceed the fair market value of the property purchased with the loan proceeds. An investment program exists, for example, when trustees determine that a specific percentage or amount of plan assets will be invested in residential mortgages under specified conditions.

This exception to TEFRA's rules was provided because Congress recognized that loan programs of this type serve important purposes and are not subject to the perceived abuses that may exist with other types of loans. Any bill affecting the treatment of plan loans as distributions should provide an exception for plan investment programs. In addition, any legislative history should emphasize that the statutory loan restrictions do not apply to adequately secured investments made in the ordinary course of an investment program, even if the plan participants are among the targeted market.

8. Other Alternatives. If taxes should be raised, they must be raised. Whether this increase should result from new excise taxes, from changes in the rates applicable to business or those applicable to individuals, or from other measures is beyond the scope of our expertise. We can say, however, that new taxes on essential employee benefits -- however appealing they may seem as hidden, "non-tax" revenue-raisers -- would be unfair, ineffective, and extremely bad social policy.

Mr. STARK. Thank you.
Mr. Franceski.

STATEMENT OF GERALD B. FRANCESKI, MEMBER, EXECUTIVE COMMITTEE, THE BANKERS COMMITTEE FOR TAX EQUALITY; AND PRESIDENT, COMMUNITY BANK & TRUST CO., FOREST CITY, PA

Mr. FRANCESKI. Mr. Chairman, members of the committee, my name is Gerald Franceski. I am president of Community Bank & Trust Co., Forest City, PA. I appear today as an executive committee member of the Bankers Committee, a coalition of approximately 1,000 banks concerned about fair tax policy. Most of the banks in our group are institutions with assets of less than $100 million.

We have a detailed statement that we have presented, and I ask that our written statement be included in the record of these hearings.

The Ways and Means Committee is faced with the difficult task of achieving significant budget deficit reduction for fiscal year 1988. While we generally believe spending reductions are the best option for cutting the Federal deficit, the Ways and Means Committee has agreed to raise revenues of approximately $19 billion in fiscal year 1988 and more in following years. If revenues must be raised, this committee should determine who is not currently making a fair contribution.

As the first option, the list of possible tax increases is long. We will restrict our comments to an area of long-standing concern to our group and of increasing concern to all community banks. Our discussion involves one of the reform proposals noted in the June 25, 1987, joint committee print of possible revenue options, taxation of credit unions.

The Tax Reform Act of 1986 changed drastically taxation of banks. Bad debt reserves deductions were eliminated for large institutions; deductions for investment in state and local bonds were limited; cash basis accounting is no longer an option for many banks; and the new minimum tax will hit banks hard.

Generally, tax burdens for banks have increased. This increases our competitive disadvantage with our commercial, non-profit competition, tax-exempt credit unions. The competitive problem has toughened substantially. Nationally, there are 16,000 credit unions with $170 billion in assets. During 1986, credit unions gained 5 million new customers. Credit unions currently offer VISA and MasterCard, automated teller machines, discount brokerage, an array of loan products including commercial loans.

In the market area of Community Bank & Trust, we compete with the IBM Corp. credit union. The IBM credit union has assets of over $500 million. It is an interstate bank with tax subsidized loans and deposits. Their customers are encouraged to participate in direct deposit programs, and banking services are offered to all family members, even if the member who originally joined has left the company.

Importantly, many credit unions operate on geographic common bonds, opening their field of membership to cities and towns. Overall, credit union customers are more affluent and more concentrat-

ed in professional occupations than non-members. Credit union customers are more likely to own their own homes, and a far greater portion have income in excess of $28,000. Tax exemption, combined with the powerful halo of selling services as a nonprofit provides enormous competitive advantage. The concern over whether this advantage and the question of whether credit union customers need a tax subsidy to do their banking has generated the recommendation of a tax policy change by the Treasury Department and the Bradley-Gephardt tax reform package.

While it is clear that congressional approval of the social benefit of credit unions remains intact, this does not preclude reviewing the rationale for the original exemption with contemporary economic and social settings. Credit union representatives stress that credit unions are different from banks, savings and loans, and consumer finance firms because they are cooperatives. The Ways and Means committee should act on this assertion and tax credit unions with reasonable common bond membership requirements as cooperatives.

Essentially, this concept, as presented by the Joint Committee print, is simply an attempt to conform credit union taxation to current law regarding mutual-type organizations. Those credit unions that prefer to operate with open membership guidelines should be taxed as any other financial institution.

We appreciate the opportunity to present our views.

[The statement of Mr. Franceski follows:]

THE BANKERS COMMITTEE

For Tax Equality

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ARTHUR T. ROTH
Partner
Stony Brook, New York

President
EDWARD A. DELANEY II
Washington, D.C.

Secretary-Treasurer
DONALD A. ROTH
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Legislative Counsel
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Stamford, Conn.

Administrative Assistant
CLAIRE E. JEFFERY
Washington, D.C.

TESTIMONY OF GERALD B. FRANCESKI BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON BEHALF OF THE BANKERS COMMITTEE

POSSIBLE REVENUE PROPOSALS FOR FISCAL YEAR 1988

JULY 8th, 1987

1615 M Street, N.W., Suite 220 • Washington, D.C. 20036 • (202) 466-8308
A Special Committee of the National Tax Equality Association

Mr. Chairman, Members of the House Ways and Means Committee, The Bankers Committee appreciates this opportunity to present our statement. My name is Gerald B. Franceski. I am President of Community Bank & Trust Company of Forest City, Pennsylvania. I appear today as an Executive Committee Member of the Bankers Committee, a coalition of about 1,000 banks concerned about fair tax policy. Most of the banks in the group are institutions with less than $100 million in assets.

We applaud the tax committee's efforts to meet deficit reduction targets for the fiscal year 1988. No doubt, it is a difficult task, but the huge budgets of recent years, $231 billion in 1986, must be significantly reduced if we are going to maintain price stability and economic growth. To consider that we are going to spend $139 billion on interest to service the national debt is a terrible waste of taxpayers hard earned money. While there is much debate over the spending priorities, it is clear that we need an agreement between the Congress and the President to ensure real deficit reduction. Your efforts must be focused on achieving such an agreement.

The recently produced budget resolution deficit reduction target of $36.8 billion signals good intentions, but more importantly, only specific actions by Congress will ensure that the deficit will in fact decline year by year. While we believe spending reductions are the best option for curtailing the deficit, the Ways and Means Committee has agreed to raise revenues as instructed by the budget resolution of approximately $19.3 billion in FY 1988 and more in following years. In line with achieving a budget agreement, your committee indicated it would prefer not to raise tax rates, but instead, examine excise taxes and other revenue possibilities or reforms not completely addressed by the Tax Reform Act of 1986. We respectfully suggest that the Members of the Ways and Means Committee determine if there are businesses or taxpayers not already paying a fair share and consider these as first options for revenue enhancement.

The Tax Reform Act of 1986 drastically altered taxation of commercial banks and savings and loans. Percentage method bad debt reserve deductions were eliminated for banks with assets of $500 million or more; deductions for investment in state and local bonds were limited severely; cash basis method of accounting was eliminated for institutions with $5 million in gross receipts and more; cash basis method appears to have been eliminated retroactively on short term customer loans for all banks regardless of size; and the new minimum tax hits hard at banks holding previously exempt bonds.

In light of these major changes and the ensuing considerable tax and tax compliance burden on the industry, we would oppose any new burdens. Listed as revenue options in the June 25, Joint Committee Print are a number of such proposals: including a five percent corporate surtax; extension of 1986 tax rate schedules for corporations for one year; and increasing the percentage rate of the minimum tax. While we generally feel our tax burden is sufficient, this is not the only motivation and, in some cases, not the primary motivation for opposing the above-mentioned revenue options. The commercial banks in our coalition are concerned about our effective tax rate as compared to a large segment of our competition which enjoys a zero percentage tax rate. I refer to our commercial non-profit competition; tax-exempt credit unions.

Commercial non-profit competition has gained increasing attention in Congress and the media over the past few years. Last month, the Ways and Means Oversight Subcommittee held

hearings on the effectiveness of the unrelated business income tax on non-profits and examined changes in the operations of non-profits. The 1985 White House Conference on Small Business third highest recommendation called upon government to eliminate unfair competition. For community banks, non-profit competition means credit unions.

The Competition is Tough and Substantial

Nationally, there are almost 17,000 credit unions with total assets growing to $175 billion to March 1987. Percentage growth in 1986 compared to 1985 and earlier years has surpassed savings deposits and loan growth for all other financial segments. In 1983, credit unions held $54 billion in savings. This figure reached $126 billion by mid-year 1986 and $162 billion by March 1987. The growth rate for the year 1986 was more than twice the deposit growth rate for commercial banks. Through March 1987, percentage increase in savings for a twelve month period was 22 percent.

Figures for loan growth are equally impressive. During 1986, loans at all credit unions grew from $74 billion to $96 billion or more than 13 percent -- a substantial growth figure during a period of lower loan demand for most financial institutions. As noted in an American Bankers Association monthly, the April 1987 ABA Banking Journal, "credit unions membership growth figure for 1986 is the highest since 1979." Credit unions now have over 55 million customers. An examination of new customers that contribute to this growth raises questions of the need and fairness of continued federal tax exemption.

New Products and Services Provide High Income Customers

Historically, infant industries have been granted tax subsidies to promote anticipated benefits to the American public. Judiciously, Congress has been called upon to remove tax favoritism and other regulatory benefits when self-sufficiency is achieved. When one examines the viability and robust condition of the credit union industry, it is obvious that tax exemption is no longer necessary. Importantly, this committee must examine more than the growth figures to determine who are the customers of credit unions. The customer profile is much different than what might be expected from a "self-help" organization intended to provide financial opportunities for low-income Americans. In fact, examination of customers reaches the heart of our argument against continued tax exemption for credit unions. Have credit unions drifted away from their non-profit and/or mutual type of organizational format?

The Credit Union National Association has from time to time, published a national member survey. This extensive report contains nearly 100 tables and provides considerable information on typical credit union members and their use of financial services. The survey covers members and, for comparative purposes, non-members as well. While the study is slightly biased toward members of smaller credit unions, it is the best information available. To gain insight about the members of large credit unions, simply consider some of the top credit unions by name. The Navy Federal Credit Union with $2.1 billion in assets, the United Air Lines Credit Union with $1.1 billion in assets and the State Employees of North Carolina credit union with $1 billion in assets do not have a majority of large percentage or low-income customers.

Overall, the study found that credit union members are somewhat younger, more affluent and more concentrated in professional and managerial occupations than non-members. Credit union customers are more likely to own their own homes, and a great portion have incomes above $40,000.

It is interesting that credit unions are viewed most favorably on price comparisons rather than services by survey respondents. Best loan rates and highest interest rates on savings were primarily motivations for membership. An interesting response and one gladly accepted by commercial bank competitors is the fact that only one-third report that they bank exclusively with credit unions. This is contrary to credit union representative's expressions that members rely on the credit union for banking services.

The customer profiles raise the spector that credit unions are simply transferring federal benefits to individuals with the good fortune to work at a company that sponsors such an institution regardless of need or income.

Growth and expansion are the goal of any business organization, and the desire to aggressively compete with other sectors of the financial industry has moved credit unions toward higher income customers. The more affluent and better educated customer base of credit unions as outlined by the Credit Union National Association survey is due not only to pricing advantages bestowed by Federal and State tax benefits, but also by an array of new products and services designed to attract such a high income market segment.

Consider the following examples of products and services, who might enjoy such products and whether the Federal government should subsidize the activities.

1) Litton Employees Credit Union offers members a discount brokerage product with margin accounts, and option trading. Similar services are offered by a number of credit unions including IBM's credit union service corporation, American Brokerage.

2) Over 3,000 credit unions offer VISA and Mastercard to their customers.

3) Credit unions may now provide commercial loans by an act of the National Credit Union Administration Board. Other popular loan products include 1st and 2nd mortgages and consumer loans up to $50,000.

Along with new products, the deterioration of "common-bond" requirements for credit union membership allow credit unions to compete with banks and savings and loans for customers among the general public. Credit union regulators have determined that senior citizens that are members of a senior club (even if started by the credit union) quality for membership. The American Bankers Association objected to the new policy saying "its clearly outside the intent of the law" regarding common bond membership. Many credit unions operate on a "geographic" common-bond, providing for town or city-wide customer solicitation base. Another popular method of increasing membership includes expanding common-bond to so-called related companies. The following examples of expanded common bond provided by our members illustrates this trend.

1. Roanoke General Electric Employees FCU, Salem, VA (assets - $21,754,319), can increase its membership by 90,705

from members of the Alumni Association, Virginia Polytechnic Institute and State University in Blacksburg, employees of FIC Staff Services, Inc. in Charlottesville, employees of Carter Associates, Inc. who work at Roanoke Airport Marriott, Blacksburg Marriott Hotel, and Carter Associates, Inc. corporate office in Salem.

2. Mission FCU, San Diego, CA (assets - $236,639,000), can increse membership by 40,037 from employees of Scripps Bank and members of Ninth District Parent Teachers' Association, Inc. who work in San Diego County.

3. Bell International FCU, Pittsburgh, PA (members - 7,028), can increase membership by 6,849 from employees of Health & Welfare Planning Association in Pittsburgh, members of Pittsburgh Typographical Union No. 7, and members and employees of members of the North Hills Area Chamber of Commerce in Pittsburgh.

4. Nationwide FCU, San Francisco, CA (members - 6,924), can increase members by by 5,071 from employees of Miller Grove Travel Associates, employees of Columbia Savings and Loan who work in Mill Valley, employees of Crown Newsprint Sales and Forest Terminal, and retirees and senior citizens of the Zelpack Association in Emeryville.

5. Alburquerque U.S. Employees FCU, Alburquerque, NM (members 13,712), can increase membership by 4,170 from employees and members of the State Bar of New Mexico who qualify for membership, and employees of members who work in Bernililo, Sandoval and Valencia Counties.

6. Leander Community FCU, Cedar Park, TX (potential members - 24,500), Field of Membership consists of persons who live or work in portions of Williamson County.

7. Wright Patman Congressional FCU, Washington, D.C. (members - 22,430), can potentially increase membership by 9,200 from lobbyists and employees of lobbyists registered with the Clerk of the House of Representatives and who work on capitol Hill.

8. Forest Area FCU, Fife Lake, MI (members - 1,569), can potentially increase membership by 10,688 from persons who reside or work in Kalkaska County, MI.

How do these expansions meet well-defined common-bond requirements? Clearly, they fail to meet this vital test which qualifies the institutions for favorable tax treatment.

Tax Exemption Elimination Recommended

The changes in the operation and customer base of credit unions resulted in recommendation for a change in tax policy by the Administration and by the Bradley-Gephardt tax reform package. Under the Treasury Department plan outlined in "The President's Proposals to the Congress for Fairness, Growth and Simplicity," credit unions would be subject to federal income tax on retained earnings. The report states that exemption "gives CUs a competitive advantage in attracting deposits from other financial institutions. Equity and neutrality demand that all financial institutions be taxed on all net income." This concept is similar to the credit union provision in the Bradley-Gephardt tax package.

While many commercial bankers would prefer to see taxation without regard to mutual ownership and the corresponding limitation on economic income of cooperatives, we endorse this tax concept for credit unions retaining a strict common-bond membership. Essentially, this proposal is an attempt to conform credit union taxation to current law regarding mutual type organizations. In fact, complete tax exemption is highly unusual treatment for cooperative membership organizations. Credit unions that want to compete in the financial market for customers from the general public, should be denied a member dividend deduction and taxed accordingly.

Credit union representatives maintain that credit unions are financial cooperatives; they should be taxed as such. The Ways and Means Committee revenue proposal accomplishes this, and would move toward fair and equitable tax policy.

Thank you very much.

Mr. STARK. Thank you very much.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I would also like to thank the panel, and may I say at the outset, I do not like the proposal that we are considering as far as ESOPs are concerned, because over the years I have certainly supported the creation of employee ownerships, and especially through the ESOP, some of the incentives for leveraged ESOPs.

I think a good example is one in my district which I visited some months ago, the C. Ray Bolt Co., which has a good ESOP plan. In fact, from 1970 when the company was first organized, they have grown from $10 million in sales to $465 million in sales in 1987. They are located throughout America, but their largest facility, rightfully so, is in my district. You may be familiar with that one, but there are others that I could name around the country.

Mr. Braun, what would it do to companies like that which have been able to grow? Their employees have grown with them and the company grows each year. And we think that has been a very successful operation because employees have felt they have been a part of the company.

Mr. BRAUN. Congressman Duncan, there is a very special synergism that takes place in an employee-owned company. It is almost difficult to describe without you actually being there. You have been there, sir. You have seen it.

Mr. DUNCAN. Yes, sir.

Mr. BRAUN. I can tell you that there is nothing that has been invented in business yet that is as effective as employee ownership, particularly as it gets closer and closer to 100 percent.

The method of leveraging is the very best possible way by which employees can fully and completely own their company. When this is coupled with participatory management, there is an unbelievable growth that takes place in energy in the way in which the company grows. And I can tell you, if those tools disappear or if they become prohibitive in their implementation, we are going to see a very sad, sad decline in productivity in this country, because it is the one organizational tool we have got that works, the one that is proven, the one that there are very few exceptions to, and those ESOP's just badly conceived. But any of the ESOP's that are even halfway decent in their organization and in their operation and in their structure are just miracles of productivity.

I must say that since you have seen it, I am delighted to know that you have seen such a company and that you have seen the tremendous gains that have happened with that kind of productivity brought about by the ESOP implementation.

Mr. DUNCAN. OK. I will yield back the balance of my time. I want to again thank the panel, Mr. Chairman. Thank you.

Mr. STARK. Thank you, Mr. Duncan.

Mr. Franceski, it is good to see the bankers here looking for tax equality, and I assume you support the Dorgan proposal for increased enforcement.

Mr. FRANCESKI. Certainly.

Mr. STARK. And I assume that you are going to lead the fight for the reporting and the withholding of interest and dividends?

Mr. FRANCESKI. Certainly not.

Mr. STARK. Well, when you decide to do all the right things, then maybe some members of this committee will look with favor. Many of us remember back to the bankers' campaign to cost us $8 billion a year by fighting the withholding of interest and dividends, and I am sure that Chairman Rostenkowski and former Chairman Dole will remember that fondly as they wonder whether or not they should help you in resisting unfair competition.

Mr. FRANCESKI. I would like to totally disagree with that statement. The mechanism is already in place that reports all dividend and interest.

Mr. STARK. We are talking about withholding. You can disagree with it. There are many of us who have a long memory.

Mr. FRANCESKI. But the mechanism was in place. We report all dividends and interest and always have.

Mr. STARK. We are talking about withholding, Mr. Franceski.

Mr. FRANCESKI. Why would you need the withholding if it is reported?

Mr. STARK. Because it would pick up a lot of revenue from people who do not pay.

Mr. FRANCESKI. Well, if you already have the information, they have to pay you if you have any type of system.

Mr. STARK. Well, the system does have a few flaws.

Mr. FRANCESKI. More than a few.

Mr. STARK. At any rate, I just wanted you to know that the bankers have some friends of the Senate Finance and the House Ways and Means Committee who do remember their disagreement of some years back. I am sure they will take that into consideration.

Mr. Schmidt, do you think and agree that for those employers who have large unfunded liabilities for their pension and health benefit plans in particular, do you agree that they should be forced as quickly as possible to set aside reserves to fund those liabilities for retiree health plans?

Mr. SCHMIDT. Well, we are certainly in favor of funding any of the liabilities that exist. We would think, however, that there should not be counterincentives in the tax law; for example, some of the reserve limitations and specific proscriptions from TEFRA on funding retiree health care coverage.

Mr. STARK. I guess the Chair would agree with you as long as that does not hurt funding of other liabilities, which these employers may have incurred for retirement. There is some question and some debate whether so-called excessive reserves in the pension ought to be used to fund health benefits. I know that Mr. Georgine is the champion of the working people. I wonder if Mr. Georgine could inform you if he knows of how many of these ESOP companies have union bargaining units.

Mr. SCHMIDT. The ESOP companies? Well, I could ask Mr. Georgine in his union capacity.

Mr. STARK. I just wondered if he had that information at the tip of his fingers.

Mr. SCHMIDT. I will pass that on to him, Mr. Stark.

Mr. STARK. Now, Mr. Braun, all I can say has Mr. Kelso recovered?

Mr. BRAUN. I beg your pardon?

Mr. STARK. Has Mr. Kelso recovered? I think he had a nervous breakdown some years ago when he invented this ESOP plan, and I wonder if he is well.

Mr. BRAUN. I am not aware of the fact that he was in the hospital.

Mr. STARK. He once stated that he not only thought ESOPs would be the best tax dodge in the world, but they could cure communism. I must say that the only thing I will not miss about Russell Long is the fact that we now should be able to eliminate ESOPs, which are one of the most wonderful tax loopholes that anybody ever created.

Mr. RANGEL. Would the chairman yield on that point?

Mr. STARK. Sure.

Mr. RANGEL. We want the Chair to know that Russell Long may be gone, but I am not and I do believe that this is one of the few vehicles that working people have to become owners and a part of management. We all may not be fortunate to be heirs to legacies, but it is possible through participation of employees in stock sharing and buying parts of the company that employees can, indeed, become a part of management. At that time I think the success rate or failure has not been far below that of just the managerial skills that we have in the United States.

So even though the good Senator may not be with us, I want you to know that you can count on this member's support for the employee stock ownership plans. Thank you, Mr. Chairman.

Mr. STARK. That is quite all right. Everybody has to spend money any way they want.

Mr. BRAUN. Thank you, Congressman Rangel.

Mr. STARK. I want to thank the panel.

Mr. Levin.

Mr. LEVIN. I have no questions.

Mr. STARK. The final panel will consist of Mr. Carter, the former chairman of the Tax and Fiscal Affairs Committee, Associated General Contractors; and Ms. Davis, the Director of divestment project for corporate responsibility, the American Committee on Africa.

Mr. Carter.

STATEMENT OF BILLY CARTER, FORMER CHAIRMAN, TAX AND FISCAL AFFAIRS COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. CARTER. Thank you, Mr. Chairman.

My name is Billy Carter, and I am here today representing the Associated General Contractors of America. AGC represents more than 32,500 firms, including 8,400 of America's leading general contracting construction firms. In the interest of time, I will summarize my statement, but I ask that the complete statement be included in the record.

Three major revisions to the Tax Code have already been enacted by Congress in the 1980's. The construction industry is still attempting to adjust to the sweeping tax changes enacted just last year which have impacted every aspect of our business, including our public and private construction markets.

Due to time limitations, I will focus on only two of our concerns, but I would like to point out one common thread. As an industry that embodies the most competitive free market ideals, we urge you to reject proposals offered in the name of revenue-raising which, in fact, will generate more paperwork than revenue and which will limit the ability of the construction industry to properly contribute to our Nation's economic well-being.

One revenue-raising option being considered is to require 100 percent of all long-term contracts, other than contracts of small businesses exempted under present law, to be reported under the percentage of completion method, [PCM], of accounting. This would be done by either requiring all contracts entered into after the end of 1987 to use PCM, or by increasing the use of PCM so that 100 percent of contracts would be covered by 1989. Either of these options would totally eliminate the completed contract method of accounting for firms with more than $10 million in annual revenues and require a construction company to pay taxes on profits it has not yet earned and before it has even produced the product or completed the sale.

AGC strongly urges the Committee to reject this revenue-raising option. Most firms in the construction industry are in the midst of a very painful transition from the completed contract method of accounting used by the industry from the inception of the Tax Code in 1918 to the new PCM, or the 60–40 method devised by the Joint Committee on Taxation last September.

These two new accounting methods were applied retroactively, and no provision was made to ease the switch in accounting method, such as a 4-year adjustment period. As a result, construction contractors with shorter long-term contracts are making the entire transition in just 1 or 2 years. This is having a very serious cash flow impact on these firms, as most are thinly capitalized and must now borrow to pay sizable tax bills.

Each of the two accounting methods now available to construction contractors are extremely complex and difficult to administer. The most significant paperwork problem facing contractors is the new lookback rule which applies under either method. While the goal of the lookback rule, correcting estimating errors, is admirable, many serious problems remain in applying the rule to construction.

The problems, which at times seem insurmountable to the construction industry, include integrating the lookback rule with the new alternative minimum tax and the correct treatment of contract disputes and lawsuits. Some AGC contractors have over 750 contracts at any one time. After a contract's completion, the lookback rule requires contractors to recalculate each previous year's taxes, compute under- or overpayments, and calculate interest owed to or by the Government. All of these calculations must be done on a contract-by-contract basis. We are talking about thousands of calculations.

With so many unresolved issues, and no regulatory guidance yet on the problems associated with the lookback rule, AGC urges Congress to reject the revenue-raising option currently under consideration of eliminating the remaining use of the completed contract method of accounting.

AGC also strongly opposes increasing for deficit reduction purposes the Federal user fees which support the Highway Trust Fund and the Airport and Airway Trust Fund.

AGC believes that any increase in these transportation user fees must be used for the sole purpose of preserving and enhancing the transportation infrastructure which underpins our Nation's economy.

Especially now—at a time when the Federal aid highway program has been reauthorized at levels insufficient to meet our Nation's pressing highway and bridge repair needs, thereby placing a heavy burden on State and local governments to fill this void—AGC believes it would be wholly inappropriate for Congress to add to that burden by preempting, for nontransportation purposes, the primary source of revenue that States and localities must rely upon to fund much needed highway improvements.

In fact, increasing Federal motor fuel taxes would not just preempt States from raising additional revenues for highway improvements; it would also undermine their efforts by significantly reducing currently available revenues. Moreover, AGC believes the dedicated, user fee-financed Federal transportation trust funds, and the vital infrastructure construction programs they support, have already been called upon to do more than their "fair share" toward deficit reduction. By limiting highway and airport improvement program expenditures below levels which these transportation trust funds can support, Congress and the administration have already allowed the cash balances in these dedicated funds to collectively balloon to almost $20 billion, just to make the Federal deficit appear less serious than it really is.

In summary, AGC believes Congress must reject the temptation to reduce the general fund deficit by increasing dedicated transportation trust fund user fees, which are so obviously needed to support the vital transportation infrastructure programs so critically important to America's economy and global competitiveness.

Thank you. I will be glad to answer any questions.

[The statement of Mr. Carter follows:]

Testimony of

Billy Carter

for

The Associated General Contractors of America

Presented to

The Committee on Ways and Means

United States House of Representatives

on the Topic of

Revenue - Raising Options

for Deficit Reduction

July 8, 1987

AGC is:

* More than 32,000 firms including 8,400 of America's leading general contracting firms responsible for the employment of 3,400,000-plus employees;
* 106 chapters nationwide;
* More than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities;
* Over $100 billion of construction volume annually.

Thank you, Mr. Chairman.

My name is Billy Carter and I am here today representing the Associated General Contractors of America. AGC represents more than 32,500 firms, including 8,400 of America's leading general contracting construction firms. These contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial, and municipal-utility facilities, and employ more than 3,400,000 individuals. I appreciate the opportunity to testify on revenue-raising options for deficit reduction now before the Committee.

Three major revisions to the tax code have already been enacted by Congress in the 1980s. The construction industry is still attempting to adjust to the sweeping tax changes enacted just last year, which have impacted every aspect of our business, including our public and private construction markets. A study of the 1986 tax law by the CIT Group and Peat Marwick recently found that the 9,300 heavy construction contractors in the study were the hardest hit of any industry, with a 151.5 percent increase in 1987 tax liability over 1986. Just a few months later two hundred revenue-raising options are now before this Committee for consideration, and many of them would once again seriously impact the construction industry.

Due to time limitations, I will focus on only a few of our concerns, but I would like to point out one common thread. As an industry that embodies the most competitive free market ideals, we urge you to reject proposals offered in the name of revenue-raising which in fact will generate more paperwork than revenue, and which will limit the ability of the construction industry to properly contribute to our nation's economic well-being.

AGC Opposes Requiring the Percentage of Completion Method of Accounting

One revenue-raising option being considered is to require 100 percent of all long-term contracts (other than contracts of small businesses exempted under present law) to be reported under the percentage of completion method (PCM) of accounting. This would be done by either requiring all contracts entered into after the end of 1987 to use PCM, or by increasing the use of PCM so that 100 percent of contracts would be covered by 1989. Both of these options would totally eliminate the completed contract method of accounting for firms with more than $10 million in annual revenues.

AGC strongly urges the Committee to reject this revenue-raising option. Most firms in the construction industry are in the midst of a very painful transition from the completed contract method of accounting, used by the industry from its inception in 1918, to the 60-40 method devised by the Joint Committee on Taxation last September.

This 60-40 method was applied retroactively and no provision was made to ease the switch in accounting method, such as a four-year adjustment period. As a result, construction contractors with shorter long-term contracts are making the entire transition in just one or two years. This is having a very serious financial impact on these firms, as most are thinly capitalized and must borrow to pay sizeable tax bills.

Each of the two accounting methods now available to construction contractors, the new 60-40 method and percentage of completion, are extremely complex and difficult to administer. The most significant paperwork problem facing contractors is the new lookback method which applies to PCM under both methods. While the goal of the lookback method, correcting estimation errors, is admirable, many serious problems remain in applying the method in construction.

The problems, which at times seem insurmountable to the construction industry, include integrating the lookback rule with the new alternative minimum tax and the correct treatment of contract disputes and lawsuits. Some AGC contractors have over 750 contracts. After a contract's completion the lookback rule requires contractors to recalculate each year's taxes, compute under or overpayments, and calculate interest owed to or by the government. All of these calculations must be done on a contract by contract basis. We are talking about thousands and thousands of calculations.

With so many unresolved issues, and no regulatory guidance yet on the problems associated with the lookback rule, AGC urges Congress to reject the revenue-raising option currently under consideration of eliminating the remaining use of the completed contract method of accounting.

AGC Opposes Increasing Transportation User Fees for Deficit Reduction

AGC also strongly opposes increasing, for deficit reduction purposes, the federal user fees which support the Highway Trust Fund and the Airport and Airway Trust Fund.

AGC believes that any increase in these transportation user fees must be used for the sole purpose of preserving and enhancing the transportation infrastructure which underpins our nation's economy.

Especially now -- at a time when the Federal-aid highway program has been reauthorized at levels insufficient to meet our nation's pressing highway and bridge repair needs, thereby placing a heavy burden on state and local governments to fill this void -- AGC believes it would be wholly inappropriate for Congress to add to that burden by preempting, for non-transportation purposes, the primary source of revenue that states and localities must rely upon to fund much-needed highway improvements.

In fact, increasing federal motor fuels taxes would not just preempt states from raising additional revenues for highway improvements; it would also undermine their efforts by significantly reducing currently available revenues. The National Association of State Budget Officers projects that diminished fuel consumption resulting from a 12 cent federal motor fuels tax increase would not only create a $3.4 billion shortfall in federal Highway Trust Fund revenues over the next five years, it would also cause an additional $4 billion to be irrevocably lost to state treasuries over the same period.

Moreover, AGC believes the dedicated, user-fee financed federal transportation trust funds, and the vital infrastructure construction programs they support, have already been called upon to do more than their "fair share" toward deficit reduction. By limiting highway and airport improvement program expenditures below levels which these transportation trust funds can support, Congress and the Administration have already allowed the cash balances in these dedicated funds to collectively balloon to almost $20 billion, just to make the federal deficit appear less serious than it really is.

In summary, AGC believes Congress must reject the temptation to reduce the general fund deficit by increasing dedicated transportation trust fund user fees, which are so obviously needed to support the vital transportation infrastructure programs so critically important to America's economy and global competitiveness.

Equitably Treating Construction Contractors Engaged in Long-Term Fixed Price Contracts Under an Oil Import Fee

A per-barrel fee on imported and/or domestic crude oil and refined petroleum products has also been suggested as an option for increasing federal revenues for deficit reduction.

The construction industry, which is a major consumer of petroleum-based products, is an industry based on open, competitive bidding and long-term, fixed-price contracts. These fixed-price contracts may take two, three or four or more years to complete. Once the low bid is accepted and the contract is awarded, a contractor is committed to accomplishing the contract at the firm bid price. The contractor does not have the opportunity, like firms in other industries, to increase the contract price to reflect increases in the cost of materials or fuel. Contractors who have bid for work prior to an import fee on crude oil could stand to lose millions of dollars due to the price increase in fuel and petroleum-based products that would occur with the imposition of oil import fees.

While contractors must assess, and price accordingly, the costs of demand and supply situations before winning contracts through open competitive bidding, AGC believes they should not be penalized by actions of their own government after contract award.

Accordingly, AGC believes that should Congress impose a per-barrel fee on imported and/or domestic crude oil, provisions must also be established to rebate to the contractor the increased costs in hydrocarbons and their derivative products on fixed-price or guaranteed-maximum price construction contracts bid on or entered into prior to the implementation of the government program which results in the increased prices.

Mr. STARK. Thank you very much.
Ms. Davis.

STATEMENT OF JENNIFER DAVIS, EXECUTIVE DIRECTOR, AMERICAN COMMITTEE ON AFRICA, AND DIRECTOR, DIVESTMENT PROJECT FOR CORPORATE RESPONSIBILITY

Ms. DAVIS. Thank you, Mr. Chairman. I want to thank the committee for the opportunity to testify today in favor of H.R. 1005 which seeks to deny foreign tax credit for any tax paid or accrued to the Republic of South Africa. Such action would be a significant further step on the road to ending apartheid, a road on which this Congress has already taken the first steps by the passage of the Anti-Apartheid Act last year.

I am executive director of the American Committee on Africa, which has been informing Americans about the struggle for African self-determination since 1953, and am by birth a South African where I trained as an economist.

The struggle for freedom in South Africa faces new challenges today in face of the continued refusal of the white minority regime to abandon apartheid. This is not a body in which I need to lecture you about the unique evils of apartheid. You know and have identified it as a system which makes skin color a crime, inevitably punishable by a life sentence of political rightlessness and economic and social inferiority.

Now, to maintain this monstrous injustice in the face of increasingly strong pressure for democratic rights, the South African Government has launched a campaign of terror with the detention of thousands and thousands of people, many of them children of 10 and 11, ferocious press censorship and other forms of oppression.

Under South African law, any person who advocates sanctions or disinvestment is guilty of subversion, for which the penalty is up to 20 years in prison. Despite this danger, South Africa's biggest trade unions and other religious and community leaders continue to call for such action.

Last year, the U.S. Congress responded to these calls by the passage of the Anti-Apartheid Act, but U.S. companies can still claim credit against their U.S. taxes for those paid in South Africa. Cutting off these tax credits would have a quadruple effect. It would send a clear signal of intent to the apartheid regime that the U.S. Congress is still deeply concerned to find peaceful ways of eliminating apartheid, and provide continuing encouragement to democratic South Africans.

It would add to the pressure already being exercised on U.S. corporations to cut off all business links with South Africa.

It would thus help to deprive the apartheid regime of a flow of funds much of which might be devoted directly to police and military repression and the implementation of apartheid.

Finally, it would have some revenue-enhancing effect in the United States.

Let me comment briefly on the potential amounts, and it will not surprise you here that the value of taxes paid by U.S. corporations in South Africa is somewhat obscure. We have used figures available from the IRS and the Department of Commerce's Bureau of

Economic Analysis to compute ballpark figures. The details are in your copies of my full testimony. I will just summarize and say that in the first three years of this decade, U.S. corporations in South Africa earned estimated incomes of over $1 billion, paid well over half a billion into apartheid's treasury, and earned some half billion in credits from the U.S. Treasury for making such payments.

Now, ending those tax credits would increase the pressure on U.S. corporations to leave South Africa and, thus, deprive the South African Government of a direct source of income. It could also be expected to enhance U.S. revenue by at least some $100 to $200 million a year.

There is extensive documentation on the role of U.S. investment in apartheid South Africa, so let me observe only that as long ago as January 1978 the Senate Subcommittee on Africa issued a report declaring the net effect of American investment has been to strengthen the economic and military self-sufficiency of South Africa's apartheid regime.

Between 1960 and 1981, the level of U.S. investment in South Africa increased ninefold, yet during that same period the South African Government expanded and entrenched its repressive apartheid system.

There is little reason now to believe that by staying there, new U.S. corporations or the old ones could change that trend. There is something particularly objectionable about providing tax credits for money paid to the South African treasury. Even a cursory examination of the South African budget reveals the extent to which such income would be used to maintain the apartheid system, paying the police and soldiers who are now occupying black townships or terrorizing black school children.

I maybe should just remind members of this committee that in South Africa the defense force is actually occupied in terrorizing people in the townships. There is a civil war in South Africa. This is not an Army defending its country against alien enemy forces; for this army the enemy is the majority of the country's population.

There are in the full testimony indications of the growth of the whole repressive machinery, and I will not repeat those figures. I would like to stress simply that the South African Government has multiplied its expenditures on police and the defense force in the last few years, and that it also hides much of its repressive activity in expenditure in other budgets. The most egregious example of this I could find was that official statements keep on pointing out that there are substantial increases in expenditure on education for black children as proof that reform is on its way. What is not mentioned is that the expenses of the troops occupying black schools are paid for out of that education budget.

Sitting here this morning, I heard discussion on the tension between growing social needs in the United States and the desire not to increase taxes further to generate revenue. Discontinuing tax credit for taxes paid to the South African Government will provide new revenue in the United States. I do not know what $200 million will buy in next year's budget in the United States, but it is certain

to be less destructive of human lives and hopes than $200 million spent by the South African Government.

Mr. Chairman, I would like to be able to prove incontrovertibly to the committee that if you took this action of cutting off tax credits today, apartheid would fall tomorrow. But we all know that is not true. However, there is increasing evidence that the international pressures being exerted on apartheid are having a significant impact on critical sectors of the white community.

U.S. action last year triggered or accelerated extensive international action against apartheid. Twenty-five industrialized democracies now have imposed various economic sanctions against South Africa. New action by Congress now could have an important impact in South Africa and internationally, carrying the message that this house will not rest until apartheid is overthrown.

Thank you, Mr. Chairman.

[The statement of Ms. Davis follows:]

The American Committee on Africa
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M. William Howard, *President*
Elizabeth Landis, *Vice President*
Jennifer Davis, *Executive Director*

TESTIMONY of Jennifer Davis,
Executive Director,
American Committee on Africa

Committee on Ways and Means
House of Representatives
July 8, 1987.

Mr. Chairman, I want to thank you for the opportunity to testify today in favor of HR 1005 which seeks to deny foreign tax credit for any tax paid or accrued to the Republic of South Africa. Such action would be a significant further step on the road to ending apartheid, a road on which Congress placed its feet firmly with the 1986 passage of the Anti-Apartheid Act. I am executive director of the American Committee on Africa, which has been informing Americans about the struggle for African self-determination and freedom since its founding in 1953.

The struggle for freedom in South Africa faces new challenges today in face of the continued intransigence of the white minority government and its refusal to abandon apartheid. People inside South Africa have faced escalating repression as they have sought to build a democratic movement. I do not need to detail the South African government's actions in this body: the detention and torture of thousands, including children as young as ten and eleven, trade unionists, community activists; "treason trials" and the prohibition of meetings and even public funerals, the banning of publications and organizations.

The people of South Africa have long called on the international community to aid them in their struggle for freedom. The late Dr. Martin Luther King Jr. and the late Albert Lutuli, President of the African National Congress, both men Nobel Peace Laureates, issued a joint appeal for action in 1962 "We...ask men of good will to take action against apartheid in the following manner:...Don't buy South Africa's products; Don't trade or invest in South Africa." Another Nobel Peace Laureate, Archbishop Desmond Tutu, has also called for strong international action.

Under South African law, any person who advocates divestment or disinvestment is guilty of subversion for which the penalty is up to 20 years in prison. Despite this danger, trade unions, the religious community, political organizations, civic groups and others continue to call for divestment and sanctions, and at home, unions have called on employers to stop deducting taxes from employees, demanding an end to taxation without representation.

In December 1985, the then newly formed Congress of South African Trade Unions (COSATU) — the largest labor federation in South Africa's history with a membership of 650,000 Black trade unionists — declared its full support for divestment. And the National Union of Mineworkers, in early 1987, passed a resolution reaffirming "its support for all forms of international pressures, including sanctions and disinvestment."

Last year, the U.S. Congress took an historic step by passing the Anti-Apartheid Act which imposed a series of economic sanctions against South Africa. As part of those sanctions, Congress prohibited most new investment in South Africa and revoked the tax treaty between South Africa and the U.S. However, U.S. companies can still claim credit against their U.S. taxes for those paid in South Africa. Cutting of these tax credits would have a quadruple effect.

1) It would send a clear signal of intent to the apartheid regime that the U.S. Congress is still deeply concerned to find peaceful ways of eliminating apartheid, and provide continuing encouragement to democratic South Africans.

2] It would add to the pressure already being exercised under the Anti-Apartheid Act on U.S. corporations to cut off all business links with South Africa.

3] It would thus help deprive the apartheid regime of a flow of funds, much of which might on average, be devoted directly to police and military repression and the implementation of apartheid.

4] It would have some revenue enhancing effect in the U.S.

As of 1985, total U.S. economic involvement in South Africa, including direct investment, bank loans and shareholdings, totaled some $8.5 billion. About 250 U.S. companies have direct investment in South Africa of $1.3 billion and many others conduct business through licensing and franchising agreements. Before I deal more extensively with the general economic and political arguments for cutting all economic links to apartheid South Africa, let me seek to provide some estimate of the financial values involved in the payment of taxes.

Figures for the amount of taxes paid to South Africa and income tax credits claimed are compiled in even years by the Internal Revenue Service's Statistics of Income division - Foreign Returns and Analysis Section. These figures are based on actual tax returns. The 1984 statistics are not yet available and are not expected before the end of the year, but it is possible to compute working estimates of the dollar values involved.

Taxable income of U.S. affiliates from South Africa in 1980 was $493,551,000 and $440,780,000 in 1982. Taxes paid or accrued and deemed paid to South Africa, including Namibia, was $228,927,000 in 1980 and $211,593,000 in 1982. This would imply an effective tax rate of about 46% in 1980 and 48% in 1982.

Although country specific information is not available, in both 1980 and 1982 about 83% of total foreign taxes paid were claimed as credits against U.S. tax. This would suggest that the tax credits claims for South Africa (and Namibia) was $190,011,000 in 1980 and $175,622,000 in 1982.

Figures are also kept by the Department of Commerce's Bureau of Economic Analysis. The BEA figures are based on survey information, and because different definitions are used, are not directly comparable to those of the IRS, but are again useful as confirming the overall parameters within which we appear to be operating. For example, according to figures published by BEA, South African Nonbank Affiliates of Nonbank U.S. Parents in 1982 had net income of $509,000,000 and paid income taxes of $373,000,000.

The BEA figures for 1983, 1984 and 1985 are only available for majority owned (more then 50%) Nonbank Affiliates of Nonbank U.S. Parents.

South African Income and Taxes Paid
by
Majority Owned Nonbank Affiliates
of Nonbank U.S. Parents
(Millions of dollars)

	1982	1983	1984	1985*
Net Income After Tax	283	388	262	148
Income tax paid	263	272	293	227
Net Income Before Tax	546	660	555	375

* preliminary

Source: BEA.

This would imply an effective tax rate of 41% in 1983, 52.7% in 1984 and 60.5% in 1985. Such estimates are rough approximations. The breakdown of foreign tax paid by type of industry is not available for any year after 1982, but net income by industry for those years is available, allowing some extrapolation to provide estimates of the taxes paid in each category.

Net Income South African
Majority Owned Nonbank Affiliates of U.S. Parents
(millions of dollars)

	All Industries	Petroleum	Manu-facturing	Wholesale trade	Finance (except banking), insurance, & real estate	Services	Other Industries
1983	388	125	153	197	2	11	#
1984	262	94	98	59	4	4	3
1985*	148	75	43	13	5	3	8

less than $500,000
* preliminary

Source: BEA

The last year for which BEA has published a breakdown of taxes paid by types of industry is 1982. These figures include all South African affiliates 10% or more owned by a U.S. parent.

1982 Taxes of South African Nonbank
Affiliates of Nonbank U.S. Parents
(millions of dollars)

All Industries	Petroleum	Manu-facturing	Wholesale trade	Finance (except banking), insurance, & real estate	Services	Other Industries
373	(D)	188	55	4	17	(D)

(D) = suppressed

Source: BEA

It should be noted that the BEA figures do not include banks. This means that Citicorp, a major U.S. investor, which recently announced its intention to withdraw from South Africa, does not show up in the figures. It is worth noting that the continuing political crisis in South Africa, coupled with a severe recession and escalating pressure in the U.S. has led to an increasing U.S. corporate exodus from South Africa. More than 70 U.S. companies ended their direct investment in South Africa in 1985 and 1986, and the trend continues. Figures for foreign income and taxes paid in South Africa can also be expected to decrease. Further, because of the drop in the value of the Rand, profits in dollar terms are also lower even if, in Rand terms, profits have remained unchanged. Profits in South Africa have also generally been down in the years since 1982, a period of severe recession. Recent reports indicate that profits may again be on the rise, but the trend is not yet clear.

The figures cited by BEA are incomplete. Thus taxes on the petroleum sector are suppressed as are the figures for "other industries." Thus $112,000,000 is not apportioned to a category. It seems reasonable to assume that the largest category would be for oil, an indication of the continuing vital role of companies such as Mobil, the largest U.S. investor in South Africa.

To sum up, in the first three years of this decade, U.S. corporations earned estimated incomes of over one billion dollars, paid well over half a billion into Apartheid's treasury, and earned some half billion dollars in credits from the U.S. treasury for making such payments.

It is worth pointing out that many U.S. companies have received investment incentives from South Africa. Again, according to BEA, 116 companies received tax concessions, 56 tariff concessions, 42 received subsidies and 29 received other incentives in 1982. All this is an indication of South Africa's eagerness to have continued U.S. investments flowing into its system.

The Role of U.S. Investment

There is extensive documentation on the role of U.S. investment in apartheid South Africa, which I will summarize only briefly.

As long ago as January 1978, the Senate Subcommittee on Africa issued a report declaring: "The net effect of American investment has been to strengthen the economic and military self-sufficiency of South Africa's apartheid regime."

U.S. computer companies, including IBM, Unisys and Control Data dominate the computer market. The single largest user of computers in South Africa is the white minority government, which accounts for 25% of all sales. The white controlled economy, from the gold mines to the banks, relies heavily on U.S. computers. "South Africa really needs U.S. companies in certain industries, particularly high tech industries and computers," noted an IBM representative in 1984.

South Africa also relies heavily on foreign corporations to refine and distribute petroleum products. Chevron, Texaco, Mobil and Shell dominate the market -- controlling more than half of all filling stations. They also refine crude oil and are legally required to sell to the police and military. Mobil's investment of over $400 million makes it the single largest U.S. investor in South Africa.

Under the National Key Points Act, all companies -- including foreign multinationals -- can be forced by the government to provide armed security of their facilities under the supervision of South Africa's defense forces. This legislation effectively makes all corporations extensions of the state. U.S. corporations argue that foreign investment is a positive force for change in South Africa. If this were true, South Africa should have witnessed steadily improving conditions since the commencement of U.S. investment. In reality, neither U.S. presence nor increased involvement has prevented the growth of the repressive apparatus of the apartheid state -- rather, it has actually contributed to its growth.

Between 1960 and 1981, the level of U.S. investment in South Africa increased ninefold. Yet during that same period the South African government expanded and entrenched its repressive apartheid system. In that same period, the government forcibly removed more than 3.5 million Blacks from "white areas" to areas designated for Blacks, and throughout the period Blacks were prevented from acquiring any meaningful political rights.

Paying Taxes to South Africa

There is something particularly objectionable about providing tax credits for money paid to the South African Treasury.

Even a cursory examination of the South African Budget reveals the extent to which such income would be used to maintain the apartheid system, paying the police and soldiers who are now occupying Black townships or terrorizing Black schoolchildren.

Several points should be stressed when assessing the South African budget. Spending for defense has increased dramatically over the past 15 years and official figures do not begin to reflect the money allocated to maintaining apartheid in South Africa and destabilizing neighboring countries. Many of the costs of defense are deliberately hidden in the budgets of other sectors of the government. Moreover, the South African government consistently underestimates its budget by an average of 7%, and

the distribution of this additional 7% is not specified in official statistics. Even more important, while the government is spending increasing amounts on repression, it still is unable to meet all of its needs. Until the economy began picking up recently, money allocated to the defense forces went mainly to operating costs, with little left over for modernizing and replacing equipment.

In the period from 1971 to 1981, the defense budget increased by 860%, to a total of R2,465 ($2,810) million in 1981. In the years following, as shown below, there has been a steady increase in defense spending. The total estimated expenditures for defense for 1987-88 is R6,683 ($3,007) million. The army, which is largely responsible for controlling the population of South Africa, now receives 39.2% of the defense budget.

1981-82	30%
1982-83	8%
1983-84	15.9%
1984-85	21.4%
1985-86	13.5%
1986-87	19.2%
1987-88	31%

Expenditures on the police force have also been increasing steadily. As shown below, the police budget has almost doubled in the past four years, from R795.64 ($541.03) million in the 1984-85 budget to R1,530 ($688.50) million in the 1987-88 budget. The 1987-88 budget represents the greatest leap, an increase of 42.9% over the previous year's budget.

Year	Million R	Million $	R % increase
1984-85	R795.64	$541.03	
1985-86	R954.71	$429.62	19.99%
1986-87	R1,071.00	$471.29	12.18%
1987-88	R1,530.00	$688.50	42.9% .uj on

Note: Rand to $ conversions are approximate as the rates have varied extensively in parts of the period referred to.

There are a number of other government departments which also contribute directly to the apartheid system. Custody and administration of justice, including the prison and court systems, has increased 29.6% in the last year to R917 ($412.65) million. The category of "protection services" listed as "other" has increased 74% to R288.4 ($129.78) million. The Ministry of Cooperation and Development has also experienced budget increases, from R1,924.43 ($865.99) million in 1984-85 to R2,348.37 ($1,056.77) million in 1985-86. Statistics on the budget of the Ministry of Cooperation and Development for 1986-87 and 1987-88 are not listed separately. Adding the budgets for these departments to that listed under defense brings the total from R6,683 ($3,007) million to R11,766.4 ($5,294.88) million.

More importantly, the South African government hides much of its defense expenditures in other budgets. For example, official statements have pointed to substantial increases in expenditures on education as proof that the government is committed to reform. Indeed, expenditures on education rose 19.3% in 1986, and most of the increases were allocated to black primary and secondary schools. Another 19.6% increase in the budget for education was introduced in the 1987-88 budget, bringing educational costs to R9,100 ($4,095) million. 40% of the budget increase was allocated to black education. What is not mentioned is that the expenses of the troops occupying black schools are paid from the education budget.

Similarly, there have been reports that a large chunk of military expenditure was also concealed in Namibia's budget allocation. The expenses of the troops which patrol the borders of South Africa, and which are largely responsible for the raids on neighboring states, are paid from the budget of the Department of the Interior. The purchase and maintenance of any buildings or structures used by the military, which in 1985-86 cost R133 ($59.85) million, comes under the budget of the Department of Public Works and Land Affairs. The Atomic Energy Board, responsible for both military and non-military uses of nuclear technology, had a budget of R776 ($349.2) million in 1986-87, up 47.5% from the previous year's budget.

Mr. Chairman, I would like to be able to prove incontrovertibly to the members of this committee that if you took this action today, apartheid would collapse tomorrow.

We all know that is not true. But there is increasing evidence that the international pressures being exerted on apartheid are having a significant impact on critical sectors of the white community. In December 1986 Finance Minister Chris Stals went so far as to say that "if the world banking community should effectively exclude South Africa from international trade and payments systems...It would put us on the barter system overnight. That is the muscle they have on their side."

U.S. action last year triggered or accelerated extensive international action against apartheid. Twenty-five industrialized democracies have now imposed various economic sanctions against South Africa, according to the U.S. State Department. Common sanctions imposed by South Africa's trading partners included: a ban on new investments in South Africa by 20 countries; a ban on imports of gold coins (Krugerrands) by 18 countries; a ban on imports of South African iron and steel by 17 countries and a ban on new loans to South Africa by nine countries. New action by Congress could have an important impact, in South Africa and internationally — carrying the message that this House will not rest until Apartheid is overthrown.

Sources:

Financial Mail, (Johannesburg), various dates.

Quarterly Bulletin, South African Reserve Bank, June 1987

Survey of Current Business, U.S. Department of Commerce, Bureau of Economic Analysis (various dates)

U.S. Direct Investment Abroad: 1982 Benchmark Survey Data, U.S. Department of Commerce, Bureau of Economic Analysis, December 1985.

Phone conversations with Internal Revenue Service and the Department of Commerce, Bureau of Economic Analysis (June, July 1987)

Notes and explanations

Exchange rates used are:

R1=	1987.[estimate].	$0.45	1984.....$0.68
	1986.....	$0.44	1981.....$1.14
	1985.....	$0.45	

The Bureau of Economic Analysis collects information on the following categories 1) All Affiliates of All U.S. Parents; 2) Nonbank Affiliates of Nonbank U.S. Parents and 3) Majority Owned Nonbank Affiliates of Nonbank U.S. Parents. The amount and type of information varies according to the category. The first category includes all affiliates 10% or more owned by a U.S. parent. The second is the same as the first but it excludes banks, both if the U.S. parent is a bank or if the South African affiliate is a bank. The third category is the same as the second, but it includes only those that are majority (more than 50%) owned.

There are numerous differences in how the Bureau of Economic Analysis and the IRS compute their figures, which is why the two sets of figures are not directly comparable. The IRS data are based on figures from actual tax returns, while BEA reports use generally accepted accounting principles, the standard used in stockholder reports. The two methods of accounting result in significantly different figures for both revenue and expenses. For example, BEA and IRS calculate the rate of depreciation differently and they come up with different income figures. BEA and the IRS also have different definitions of income. Because BEA looks at income from the point of view of the U.S. parent, it includes interest from intercompany debt in calculating income and subtracts foreign withholding taxes and dividends on remittances to the U.S. parent. How the change in the exchange rate affects the value of assets is also handled differently. When the exchange rate goes down, as it has in the past few years, BEA treats the decline in the dollar value of the foreign assets as a capital loss, but the IRS does not. All the above items have a significant effect on the foreign income figure.

The BEA and the IRS have different definitions of income and income tax paid. BEA's figures are larger because they include the total income and income tax paid by foreign affiliate (as long as that affiliate is 10% or more owned by a U.S. parent). The IRS figure for "taxable income of foreign affiliates" and "income tax paid" only includes the amount attributable to the U.S. parent, or essentially the U.S. parents share.

Mr. STARK. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. I apologize to both of the witnesses for being delayed to this late hour, but thank you for your patience.

Ms. Davis, do you believe that cutting off the tax credits to the Republic of South Africa is a logical extension of the Anti-Apartheid Act that this Congress has passed?

Ms. DAVIS. Yes, I do, and I think it is an important next step because I think that the South Africans feel that maybe the issue will go away now. So I think it is important to keep building the pressure.

Mr. RANGEL. There are some of my colleagues that believe that if we do this as relates to South Africa, because of their repugnant human policies, that we should think about doing the same thing to Communists or dictatorships. How do you respond to that?

Ms. DAVIS. Well, I would say that the United States has taken the position which is the position of the international community that apartheid is a crime against humanity. It is a particularly unique form of social organization which I think is particularly abhorrent to people in this country, where our whole principle and philosophy is built on trying to establish a unity of many different populations. So I do not see that logic and consistency would mean because you did it to A you would have to do it to B. I think this is a very unique form of society which we are trying to deal with.

Mr. RANGEL. Did your research indicate that perhaps U.S. manufacturing firms in the area of computers were targeted for doing business in the Republic of South Africa?

Ms. DAVIS. Well, the U.S. computer companies have had a very significant share of the market in South Africa. Of course, the South African Government is the largest single purchaser of computers in South Africa. It buys about 25 percent of all computers sold.

Mr. RANGEL. Would that include IBM, UNISYS and Control Data?

Ms. DAVIS. Right.

Mr. RANGEL. And in the oil industry, do they rely heavily on——

Ms. DAVIS. About 50 percent of the market is controlled by U.S. corporations, and I should point out that the South Africans have laws which require those corporations to sell to the police and military. You cannot choose who you are going to sell to.

Also, under South African law, when we asked Mobil some years ago about their dealings with the Government, they told us that they could not reply, nor could they tell their headquarters here because this was all prohibited under the South African Official Secrets Act.

Mr. RANGEL. In addition to Mobil, does it include Chevron, Texaco and Shell?

Ms. DAVIS. Yes.

Mr. RANGEL. Do all these companies have some obligation to protect the South African defense forces, if called upon by the Government of South Africa?

Ms. DAVIS. There is an act in South Africa called the Key Points Act. Anything which is regarded as important for the whole running of the economy of South Africa, the owners of those compa-

nies are required by law to protect them, to provide security for them, and to work in collaboration with the South African defense force and the military and police.

Mr. RANGEL. As a result of U.S. national policy against the Republic of South Africa, did that trigger other industrialized countries to take any action that you know of?

Ms. DAVIS. Yes. I believe that that had a very dramatic effect, that for a long time there has been an anti-apartheid movement in Europe which has not had great success outside the Scandinavian countries and Holland. But the passage last year of the U.S. Anti-Apartheid Act generated a whole wave of actions in the European economic community and elsewhere. In fact, the United States has played a very critical role in developing a whole sanctions policy internationally and can go much further.

Mr. RANGEL. I appreciate the contribution you have made, and if you have any other information as to what U.S. firms have decided to withdraw or what encouragement we might be able to get to support this legislative initiative which I have introduced, I certainly would appreciate you sending it to me and/or the committee.

Ms. DAVIS. Thank you, Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman.

Mr. STARK. Mr. Pease.

Mr. PEASE. No questions.

Mr. STARK. Mr. Duncan.

Mr. DUNCAN. I want to thank you both for staying with us. Some of the members had to be on the floor.

Mr. Carter, you mentioned in your statement, which I briefly read, that you were having some difficulty with implementing the new Tax Code.

Mr. CARTER. Yes, sir.

Mr. DUNCAN. What are some of those problems?

Mr. CARTER. Just the transition from completed contract to percentage of completion in a short period of time creates a lot of difficulties for some of the smaller firms. I realize that firms that have revenues of less than $10 million are exempted from that transition, but the new law still covers a large cross-section of construction companies. To make this transition in a short period of time when they have limited tax and financial resources creates a real burden on them.

Many medium-sized construction firms have one accountant, and that accountant is in name only, not a CPA. He generally could be a family member or someone like that, and they are just not qualified to handle all the multitude of rules that, as of yet, have not even been written for the 1986 act. I guess really our position is leave the 1986 act alone and give us a chance to adjust to it.

Mr. DUNCAN. Do you consider companies above $10 million revenues still small up to a certain point?

Mr. CARTER. Yes, sir.

Mr. DUNCAN. Up to what point?

Mr. CARTER. Well, under the previous law, the exemption was $25 million. I think that is a reasonable level. A lot of companies that are in the $15, $20 and $25 million range still are relatively small companies because they include in their revenues all of the

subcontract work that comes under the general construction contract. So there is an extremely large revenue with no real economic benefit that is retained by the construction company.

Mr. DUNCAN. That would be pretty much true with all contractors, I guess, that subcontract out.

Mr. CARTER. Yes, sir.

Mr. DUNCAN. Thank you so much. Thank you, Mr. Chairman.

Mr. STARK. We want to thank the staff and the committee, and particularly our last panel for waiting this long to testify. Thank you very much for your contribution.

The committee will adjourn until 9:30 tomorrow morning.

[Whereupon, at 4:35 p.m., the committee adjourned, to reconvene at 9:30 a.m., Thursday, July 9, 1987.]

REVENUE INCREASE OPTIONS

THURSDAY, JULY 9, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to call, at 9:44 a.m., in room 1100, Longworth House Office Building, Hon. William J. Coyne presiding.

Mr. COYNE. Will the committee come to order and will the witnesses come to the table.

We will begin the testimony by proceeding with the first witness on the witness list, Mr. Charles DiBona, the president of the American Petroleum Institute. Then we shall proceed with the other scheduled witnesses.

You can submit your written statement for the record and also keep your remarks as long or as brief as you wish. We shall do the questioning after the full panel has given their testimony.

STATEMENT OF CHARLES J. DIBONA, PRESIDENT, AMERICAN PETROLEUM INSTITUTE

Mr. DIBONA. Thank you, Mr. Chairman. I am Charles J. DiBona, president of the American Petroleum Institute. The API is a trade association representing all segments of the petroleum industry.

The budget resolution for fiscal year 1988 calls for legislation to raise revenues. Our long-standing policy standards favors slowing the growth of spending as the means of reducing Federal deficits. However, we recognize that the Congress has already made its decision on the issue and the Ways and Means Committee is left with the extremely difficult task of providing a specified amount of new revenues.

The requirement for large tax revenues or increase of $19.3 billion in fiscal year 1988 alone has generated a variety of energy tax proposals, many of them aimed at the petroleum industry and its products.

My written statement addresses the specific proposals. In my oral comments, I will focus on general concerns which we would urge the committee to consider as you review the many tax increase options.

First, in the interest of economic efficiency and a basic fairness to workers and investors, heavy new taxes should not be imposed on one industry and its products or on just a few industries and their products in order to address what is clearly a national problem. Economists have demonstrated that imposing large taxes on a few products distorts its economic decision make and resource allo-

cation and, thus, reduces national wealth. Furthermore, burdening one or a handful of industries is unfair to those who have committed their labor or their capital to those endeavors. The Federal budget deficit is a problem that impacts every sector of our economy and affects all our citizens. The task of addressing it should be spread as widely as possible through our society.

Second, we are concerned about the negative impact that new energy taxes, would have on the economy. These should not be ignored. All taxes, including energy taxes, will have a negative short run economic impact, which would tend to offset, to some degree the anticipated Federal deficit reduction.

In addition, any energy taxes would worsen the competitive position of U.S. manufacturers, particularly those in energy intensive industries competing with foreign manufacturers, tend to reduce overall efficiency in the economy, adversely affect individuals directly by higher energy costs and indirectly by higher costs of goods, and disproportionately burden low income people.

For example, some have suggested increasing the gasoline tax as a means to raise new revenues. No doubt some money could be raised in this way, but this would come at the cost of imposing relatively greater burdens on low income persons and on consumers in the West and South. It would also aggravate inflation and reduce economic growth and would further reduce jobs and income in the domestic petroleum industry.

That brings me to our third concern, the current state of the petroleum industry.

Last year, the price of oil dropped by about one half from previous levels.

The impact on the petroleum and related support industries has been dramatic.

Even before 1986, profitability, capital expenditures on exploration and production, drilling activity, well completions and industry employment had all been heading downward. Last year, these trends greatly accelerated.

Capital investment was slashed. Drilling and other oil field activity plummeted with some indicators hitting all time lows. Employment declined by 170,000 people, not even counting indirect impacts on support industries such as banking and real estate. Rates of return on investment, a signal of the attractiveness of an industry to new infusions of capital, fell to less than two-thirds the level of other industries.

The situation in 1987 is only slightly better. The recent stabilization of crude oil prices has at least stemmed the downward trends. But drilling activity has not much increased, employment still is way down and while earnings my increase over the very low levels of a year ago, rates of return still are well below those elsewhere.

All of this suggests that new taxes on the petroleum industry would be inappropriate in the extreme. They would further weaken cash flows, employment, investment and general activity. We see no justification for such policy actions.

While the API is not advocating the adoption of any specific new taxes, we do suggest that if Congress, in addressing the deficit, intends to raise revenues, a broad based tax, meeting the following

minimum standards would have the least adverse impact on the economy:

First, it should avoid penalizing U.S. manufacturing in domestic and foreign markets by uniformly increasing the cost of goods sold in the United States, regardless of where produced, while not increasing the cost of goods exported from the United States.

Second, it should be neutral in impact on individual competitors and industries with regard to choice of investments or consumption expenditures or form of organization.

Third, it should not sharply affect the distribution of the overall tax burden by being overly regressive or progressive.

Fourth, it should avoid negative impact on incentives to save and invest.

I appreciate the opportunity to testify today and I would be happy to answer any questions. Thank you, sir.

[The statement of Mr. DiBona follows:]

STATEMENT OF THE

AMERICAN PETROLEUM INSTITUTE

INTRODUCTION

This written statement is intended to accompany the oral statement of Charles J. DiBona, President of the American Petroleum Institute before the House Ways and Means Committee regarding revenue increase options. The API is a trade association representing all segments of the petroleum industry.

The Budget Resolution for Fiscal Year 1988 calls for legislation to raise revenues of some $64 billion over the next three fiscal years. API's long-standing policy favors slowing the growth of spending as the means of reducing federal deficits. However, we recognize that the Congress has already made its decision on that issue and the Ways and Means Committee is faced with the extremely difficult task of providing a specified amount of new revenues.

The requirement for large tax increases--$19.3 billion in FY 1988 alone--has generated a variety of energy tax proposals, many of them aimed at the petroleum industry and its products. This statement will address certain of those proposals, and will also set out some general concerns which we would urge the Committee to consider in its review of the many tax increase options.

First, in the interest of economic efficiency and of basic fairness to workers and investors, heavy new taxes should not be imposed on one industry and its products, or on just a few industries and their products in order to address what is clearly a national problem. Economists have demonstrated that imposing large taxes on a few products distorts economic decision making and resource allocation, and thus reduces national wealth. Furthermore, burdening one or a handful of industries is unfair to those who have committed their labor or their capital to those endeavors. The Federal budget deficit is a problem that impacts every sector of our economy and affects all of our citizens. The task of addressing it should be spread as widely as possible through our society.

Second, new taxes on the petroleum industry would be inappropriate in the extreme. Last year, the price of oil dropped by about one half from previous levels. The impact on the petroleum and related support industries has been dramatic.

Even before 1986, profitability, capital expenditures on exploration and production, drilling activity, well completions and industry employment had all been heading downward. Last year, these trends greatly accelerated.

--Capital investment was slashed.

--Drilling and other oil field activity plummeted, with some indicators hitting all-time lows.

--Employment declined by 170,000 people, not even counting indirect impacts on support industries such as banking and real estate.

--Rates of return on investment, a signal of the attractiveness of an industry to new infusions of capital, fell to less than two thirds the level of other industries.

The situation in 1987 is only slightly better. The recent stabilization of crude oil prices has at least stemmed the downward trends. But drilling activity has not much increased, employment still is way down, and while earnings may increase over the very low levels of a year ago, rates of return still are well below those elsewhere.

New taxes on the petroleum industry would further weaken cash flows, employment, investment and general activity. We see no justification for such policy actions.

ENERGY TAXES

A. General

All taxes -- including energy taxes -- will have a negative short-run economic impact. The Consumer Price Index (one measure of inflation), Gross National Product growth (output) and employment will all be adversely impacted by enactment of an energy tax. The short-run "feedback-effects" due to lower economic activity would tend to offset, to some degree, the anticipated federal deficit reduction amounts. Moreover, the accompanying higher energy prices could very well reverse the deficit-improving stimulus of recent lower oil prices.

Imposing an energy tax would also create a competitive disadvantage for U.S. manufacturers both domestically and internationally. Unlike the 1970's oil price shocks, a unilateral energy tax will hurt only U.S. industries. U.S. manufacturers would be disadvantaged compared to foreign competitors who could send their products into the U.S. free of the cost of the tax. Exported U.S. goods would be similarly disadvantaged in world markets. Traditional heavy consumers of energy such as agriculture and "smokestack" industries are likely to be harmed more by an energy tax than by other forms of taxes. There would also be a disproportionate negative impact on domestic auto sales and auto industry suppliers. Other energy-dependent industries such as steel, petrochemical, and aluminum would have higher production costs, lower capacity utilization, and more unemployment.

Individuals would also be adversely affected by the imposition of an energy tax--both directly and indirectly. Such a tax would raise the price to consumers of energy with no corresponding offset to their disposable incomes. Thus, an energy tax would tend to have the same effect as increasing personal income taxes. Individuals would also be indirectly affected by higher product prices due to businesses' increased production costs. These higher prices would also contribute to a general increase in the inflation rate.

Additionally, the assumption that energy taxes involve only a relatively small number of taxpayers is faulty. Thus, it must be recognized that energy taxes will result in high administrative and compliance costs.

Finally, as noted earlier, the situation in the petroleum industry today is dramatically different from that of just a few years ago. A new energy tax would tend to shrink the market for petroleum products, causing further losses of facilities and jobs in all sectors of the industry, and would lead to increased reliance on imported petroleum in the future.

For each of these reasons, any tax increase which singles out energy will have a discriminatory impact on a number of key sectors of the U.S. economy. This is neither equitable nor efficient.

B. Broad-based Energy Taxes

1. BTU Tax

Under this proposal, a broad-based excise tax would be imposed on most fuels (domestic and imported oil, natural gas, coal, nuclear energy and electric power) based on energy content (BTU's). One of the major drawbacks to this proposal, in addition to the general negative features discussed earlier, is its tendency to exacerbate market distortion among the various fuels because it would be based on energy content rather than price. For example, low-price natural gas would bear a disproportionately large amount of tax relative to its price. As

another example, there would be price distortions due to the tax among anthracite, bituminous and lignite coal or between high and low-sulfur crude oil. Substantial pyramiding of the tax would also occur unless some sort of credit mechanisms for energy consumed in producing other energy were devised.

2. Ad Valorem Energy Tax

This mechanism is sometimes suggested as the alternative to the BTU tax because this method addresses the inherent differences in value attributable to the variations in BTU content and quality or location differences. As with the BTU tax, a broadly based excise tax would be imposed on most fuels. The value approach would avoid creation of new market distortions. However, the same risk of pyramiding (i.e., imposing a tax on energy used to produce other energy) which occurs with the BTU tax is inherent in this method, and some credit or refund mechanism to avoid the build-up of taxes is critical. The same general adverse effects of an energy tax noted in the first section -- reduced GNP, increased inflation, harm to U.S. industries' competitive position in foreign and domestic markets, increased costs to consumers, etc. -- apply to this tax proposal as well as all the others discussed herein.

C. Broad-based petroleum tax

In general, because an "oil only" tax would be imposed on a narrower base than an all energy tax, the rate of tax would be higher and the effects on oil using consumers--both individuals and industries--correspondingly more severe. An oil-only tax would be particularly damaging to industries that use relatively large amounts of oil as inputs, such as the petrochemical and agricultural industries. Such a tax would also reduce the demand for products such as automobiles that use oil products intensively. In addition, an oil only tax would create regional inequities in the per capita cost of energy. Those sections of the country most heavily dependent on crude oil and its products for heating and transportation would bear more of the tax burden than other areas. It can be expected that political pressures would mount to exempt certain products (e.g., heating oil) from an oil-only tax. Such exemptions would increase the burden on non-exempt users in order to raise a given amount of revenue, and also would increase the administrative complexity of the tax.

D. Motor fuels tax increases

Some have suggested increasing the gasoline tax as a means to raise new revenues. No doubt some monies could be raised in this way, but it would come at the cost of imposing relatively greater burdens on low income persons and on consumers in the West and South. Just as with a tax on all oil, it would aggravate inflation and reduce economic growth, and would further reduce jobs and income in the domestic petroleum industry.

E. Gasoline Tax Collection at Refinery Gate

One of the options listed by the Joint Committee on Taxation would provide for collection of the gasoline excise tax at the refinery gate. API opposes this proposal.

The Tax Reform Act of 1986 included a major change in the method of collection of the federal gasoline tax to go into effect January 1, 1988. All segments of the industry worked with the tax writing committees and the Treasury to devise a system which all agreed would address the problem of tax evasion and still maintain relative competitive neutrality of the gasoline marketing system.

Moving the point of collection to the refinery gate would cause major changes in the gasoline manufacturing and distribution systems which could lead to competitive distortions and to spot shortages of gasoline.

INTANGIBLE DRILLING COSTS AND PERCENTAGE DEPLETION

A. General

Several revenue raising options involve modifying the tax treatment of intangible drilling costs and depletion. These proposals include repealing expensing of IDCs, repealing the remaining percentage depletion for independents, increasing the percentage of Sec. 291 cutbacks, and across-the-board reductions in the value of certain preferences including IDC and excess percentage depletion. API opposes such proposals because they would have the effect of making oil exploration and production activities less profitable and thereby cause a reduction in investment.

B. Intangible Drilling Costs

Intangible drilling and development costs (IDCs) are costs incurred for items which, in themselves, have no salvage value and are "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. 1.612-4(a). Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

Under Sec. 263(c) of the Internal Revenue Code and Treasury Regulations promulgated thereunder, taxpayers are permitted to deduct currently IDCs for oil and gas wells and wells drilled for geothermal deposits in the United States. Only the holder of a "working" or an "operating" interest (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDCs. Moreover, the election to deduct IDCs must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years. Sec. 291(b) requires that in the case of an integrated oil company, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.

Current deduction of IDC expenditures has been a part of oil and gas tax law since the inception of the income tax. The tax treatment of IDCs was an outgrowth of the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our nation's oil and gas resources. Its importance is widely recognized as it helps to attract investment into oil and gas development despite the high financial risks and costs. The development of domestic oil and gas resources still can be aided by the rapid recovery of IDCs for tax purposes. Indeed, financial risks have escalated as the industry must more frequently drill in high-cost, hostile offshore and frontier environments. Many members of the industry, both large and small, do not readily have the cash resources or borrowing ability to carry the additional costs imposed by deferring deduction of drilling expenditures. For many taxpayers, the immediate cash flow generated by the IDC deduction can be an absolute prerequisite to participation in the industry.

C. Depletion

The Tax Reduction Act of 1975 added Sec. 613A of the Internal Revenue Code to eliminate percentage depletion on oil and gas production. Certain exemptions were provided, however, including a limited exemption for independent producers and royalty owners. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages exploration and production of oil and gas by recognizing the high risks and the enormous capital outlays required to replace reserves today in the industry.

Congress first adopted percentage depletion in 1926 as a replacement for "discovery value depletion". Percentage depletion is designed to encourage drilling activity and to approximate the cost of replacing reserves currently produced. Depletion calculated on the percentage method allows the owner of the oil or other wasting natural resource to recover a percentage of gross income subject to certain limitations. In the case of oil and gas, the current rate of percentage depletion for those eligible is 15 percent.

Many of the underlying reasons for enacting percentage depletion initially, i.e. high risk and high cost for replacing a depleting asset, justify its continuation today. Risks remain high; the industry experienced dry holes on over 80% of all wildcat wells drilled. Furthermore, domestic production has begun to decline again so that efforts to encourage domestic production are needed to stem the decline.

Rising prices through 1980 encouraged the oil and gas driller in finding oil and gas. Undoubtedly, however, some wells were not drilled and some production was forfeited by the removal of percentage depletion for integrated oil companies. Last year the price of oil dropped by about one half from previous levels, and the situation in 1987 is only slightly better. Percentage depletion ameliorates the effect of the price decline to some extent for independent producers. API believes that percentage depletion was and remains an effective replacement cost recovery mechanism which encourages the production of oil and gas.

CONCLUSION

New or increased taxes on the petroleum industry would further reduce returns on investment and sources of funds to an industry already devastated by declining prices. Furthermore, new taxes on energy, depending on their form, will either jeopardize the energy or the economic well-being of this country, or will do both.

While the API is not advocating the adoption of any specific new taxes, we do suggest that if Congress, in addressing the deficit, intends to raise revenues, a broad-based tax meeting the following minimum standards would have the least adverse impact on the economy:

1. It should avoid penalizing U.S. manufacturing in domestic and foreign markets by uniformly increasing the cost of goods sold in the U.S. regardless of where produced, while not increasing the cost of goods exported from the U.S.

2. It should be neutral in impact on individual competitors and industries with regard to choice of investments or consumption expenditures or form of organization.

3. It should not sharply affect the distribution of the overall tax burden by being overly regressive or progressive.

4. And, it should avoid negative impact on incentives to save and invest.

Mr. RANGEL [presiding]. Could we now hear from Mr. Buckley.

STATEMENT OF JOHN G. BUCKLEY, VICE PRESIDENT, GULF OIL DIVISION OF CUMBERLAND FARMS INC., AND CHARLES H. DOWNEY, PRESIDENT, BUCKLEY & SCOTT CO., INC., BOTH ON BEHALF OF THE NEW ENGLAND FUEL INSTITUTE, THE EMPIRE STATE PETROLEUM ASSOCIATION, THE NEW JERSEY FUEL MERCHANTS ASSOCIATION, AND THE INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

Mr. BUCKLEY. Thank you, Mr. Chairman. My name is John Buckley. I will submit my statement for the record. I am a vice president of the Gulf Oil Division of Cumberland Farms, headquartered in Westboro, Mass. We market in 11 Northeast States and Florida. And with me today is Charles Downey, who runs Buckley & Scott—no relation to John Buckley—a very large retail home heating oil company that operates in Rhode Island and Massachusetts.

Mr. Downey is chairman of the New England Fuel Institute's legislative committee.

I am speaking this morning on behalf of the Empire State Petroleum Association, of the great State of New York, the New Jersey Fuel Merchants, the New England Fuel Institute and the Independent Fuel Terminal Operators Association.

And I think what I would like to focus on is the energy revenue part of the package you are looking at and specifically on oil import fees.

Mr. Chairman, there have been recent studies, both public and private, that show that the import fee is a grossly inefficient system that will not significantly reduce the deficit. They may, in fact, and are probably likely to, increase the deficit.

If I can make one point clear today, it is this: Import fees do not help the Treasury or the taxpayers of this Nation. They simply transfer wealth from consumers to oil producers. They should not even be considered by this Committee in the control and the context of deficit reduction.

Even your own Committee Options Analysis acknowledges that two-thirds of the potential revenue from oil import fees would be transferred to producers.

I have nothing against oil producers, but the job of this committee presently is a job of reducing the budget deficit by $18 billion. It is not an energy policy job.

I have great regard for this committee and its fine and able staff. The job that you all did last year, I think was incredibly good for the future of our economy and our nation.

However, in looking at your analysis option paper, I was surprised to see that you did not take note of two recent crucial studies, one public and one private, completed in the last year, right on this very subject. And I urge you to read the key conclusions of those two studies which are attached to my testimony.

The first of those studies was done by the Energy Information Administration of the Department of Energy and it found, among other things, that an import fee is only 7 percent efficient in its net revenue effect.

That is, for every dollar that you collect in oil import fees, 7 cents goes to the Treasury, net.

In contrast, the broader based BTU tax of the type that Mr. DiBona talked about was 87 percent efficient; 13 times more efficient.

The second study, a private study by Data Resources, is even more dramatic. It concludes that a $5 import fee would actually increase the Federal deficit over the next 5 years.

An import fee would also have the distinction of worsening our trade deficit, a subject I know this committee is very concerned with.

Higher oil costs impact energy intensive industries most severely. These include chemicals, agriculture, steel, pulp, paper, forest products, mining, plastics, to name a few. And the loss of exports from these industries are quite likely to more than offset any additional gain you have got from reduction in imports.

Mr. Chairman, in conclusion, these two studies show an oil import fee as harmful to the economy, raises unemployment, raises inflation and slows production, causing a downturn in GNP.

We have all suffered through two oil price shocks in the last 14 years, courtesy of and administered by OPEC. Let us not have a third price shock administered by the U.S. Congress.

Mr. Chairman, I know it is hard, sometimes, to find the man behind the tree. None of us in the energy industry wants additional taxes, but if tax you must, please make it a broad base, efficient, fair, BTU tax, not an import fee.

I submit as a matter of common sense that as a revenue raising, deficit reducing device the oil import fee is dead in the water. It should be kept dead in the water. It is a nonstarter. Thank you, Mr. Chairman, and members of the committee, for listening to my testimony.

Mr. RANGEL. Without objection, your statement will be placed in the record in its entirety.

[The statement of Mr. Buckley follows:]

COALITION OF INDEPENDENT MARKETERS

STATEMENT

of

JOHN G. BUCKLEY
VICE PRESIDENT
GULF OIL, a Division of
CUMBERLAND FARMS, INC.

and

CHARLES H. DOWNEY
PRESIDENT
BUCKLEY & SCOTT COMPANY, INC.

Appearing on Behalf of

NEW ENGLAND FUEL INSTITUTE
EMPIRE STATE PETROLEUM ASSOCIATION
INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

on
OPTIONS TO INCREASE FEDERAL REVENUES

before the
UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

Washington, D.C.
July 9, 1987

Mr. Chairman. My name is John Buckley. I am Vice President of Gulf Oil, a division of Cumberland Farms, Inc., headquartered in Westboro, Massachusetts. My company markets petroleum products throughout New England and the mid-Atlantic states. I am accompanied by Charles H. Downey, President of Buckley & Scott Company of Needham, Massachusetts, which markets home heating oil in Massachusetts and Rhode Island. Mr. Downey is also the Chairman of the Legislative Committee of the New England Fuel Institute.

We are appearing on behalf of a broad coalition of petroleum product marketers. This coalition includes the Empire State Petroleum Association ("ESPA"), the Fuel Merchants Association of New Jersey, the Independent Fuel Terminal Operators Association ("IFTOA"), and the New England Fuel Institute ("NEFI"), which together represent more than 2,000 independent marketers that sell home heating oil and residual fuel to more than 6 million consumers from Maine to Florida. None of these companies own any pipelines, refineries or production facilities. We are consumers of petroleum products, and depend totally upon the availability of a secure and economic supply of the products.

I. Introduction

My testimony today concerns the Energy Consumption Taxes included in the Committee's Description of Possible Options to Increase Revenues. I will focus on the oil import tax.

Studies by government agencies and private analysts have demonstrated that this tax is grossly inefficient and will not produce significant net revenues to the Treasury. In our view, it should not be considered by the Committee as a means to generate even a small portion of the revenues needed to meet the Budget Resolution targets for FY 1988. An oil import fee should not be rejected solely because it burdens one region of the country more than others; while true, this unfairness could be balanced by other portions of the revenue package. Oil import fees have a more fundamental defect; they are among the least efficient form of revenue raising under consideration. In fact, these fees may not raise any net revenue for the Treasury because of their impact on federal spending and on the economy.

Oil import fees are energy policy disguised as tax policy. Moreover, they are bad energy policy and have been rejected many times by the Congress. Import fees primarily shift income from consumers to producers, and only incidentally may generate revenue for the government.[1/] The Committee's options analysis recognizes this fact, stating as the primary argument for an oil import fee that it "would protect domestic oil producers" and acknowledging that it "transfers about two-thirds of the potential revenue as a windfall to domestic producers."[2/]

This gross inefficiency alone should demonstrate to the Committee that this tax is inappropriate in this revenue package. But import fees will also increase inflation and unemployment, slow economic growth and significantly increase federal expenditures; thus it should be clear to the Committee that this tax may not generate any revenue at all, and thus does not merit a place even in the Committee's list of options.

II. Oil Import Fees Will Not Significantly Reduce the Deficit

The proponents of oil import fees base their revenue claims on the assumption that a $5 oil import fee will increase federal revenues by approximately $8 billion per year. This conclusion is endorsed by the Report of the Congressional Budget Office,[3/] and adopted in the Committee's description of options. However, on closer analysis, it is clear that oil import fees will not generate net revenues of this magnitude, and may generate no net federal revenue at all.

1/ One of the oil import taxes under consideration, the floor price on imported petroleum, would generate no revenue at all if the world price exceeds the floor price established.

2/ Description of Possible Option To Increase Revenues Prepared for the Committee on Ways and Means (June 25, 1987).

3/ Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (January 1987), p. 209.

At least two analyses in the last year -- one public, one private -- conclude that oil import fees will not generate significant net revenues for the Treasury.

A. EIA Report

In April, 1986, the Energy Information Administration ("EIA") of the Department of Energy studied the impact of lower world oil prices, and the effects of various energy taxes, on the U.S. economy.[4/]

For the period 1986-90, EIA found that a world oil price of $13 per barrel, rather than $23 per barrel, would increase GNP by 1.8 percent, reduce inflation by 2.0 percent, and create 1.1 million jobs. In addition, EIA concluded the lower crude oil price would reduce the federal deficit during this period by 13.8 percent, or an average of $16.3 billion per year, and by 11.0 percent from 1991-95, an average of $11.2 billion per year.

This result parallels analyses conducted on this subject in 1983 and 1984 by the Department of the Treasury and by the Congressional Budget Office ("CBO"). Each concluded that the U.S. economy would benefit significantly from a decline in oil prices, and that the federal deficit would be reduced substantially. The Treasury analysis concluded that a 40 percent decline in oil prices would reduce the annual deficit by $6 billion to $10 billion and a 24 percent decline would yield an annual saving of $4 billion to $5.5 billion.[5/] CBO stated that "a sizeable and permanent decline in oil prices would have a very favorable effect on inflation and on economic growth in the United States, and would significantly reduce the projected baseline budget deficit. . . ."[6/] CBO calculated that a permanent $8 per barrel reduction in oil prices would reduce the unified budget deficit by a cumulative total of $129 billion over five years.[7/]

Although the prior studies did not analyze the effects of an increase in oil prices, EIA calculated the effects of four energy taxes that would increase the price of oil: 1) a $5 per barrel import tariff on crude oil and petroleum products; 2) an 8.4 cents per gallon ($3.52 per barrel) excise tax on motor fuels; 3) a 4.6 cents per gallon ($1.95 per barrel) tax on petroleum products; and 4) a $.24 per MMBtu ($1.35 per barrel) excise tax on oil and natural gas.[8/] Significantly, the magnitude of each tax was designed to produce gross increases in federal revenues of approximately $55 billion over 5 years. However, EIA found that the taxes generate vastly different amounts of net revenue, because they have very different effects on the economy.

By far the most damage to the economy would be caused by the $5 oil import fee, which would reduce economic growth by 0.7 percent over 5 years, or about $68 billion. According to EIA, the import fee would also cause a loss of about 434,000 jobs in each of the next 5 years and increase the Consumer Price Index by about 1.4 percent per year.[9/] The economic impacts are far less severe for all the other taxes considered. EIA's conclusion is that a broader-based energy tax has far less destructive effects on the economy.

4/ Energy Information Administration: "The Impact of Lower World Oil Prices and Alternative Energy Tax Proposals on the U.S. Economy," (April 18, 1986).

5/ Treasury Department Interagency Study of Falling Oil Prices, Chapter II, p. 2 (1983) See Attachment 1.

6/ CBO, "Economic and Budgetary Consequences of an Oil Price Decline -- A Preliminary Analysis" (March 1983) at p. 1. See Attachment 2.

7/ Id. at pp. 16-17.

8/ The analysis of each of the taxes assumes a $20 world price of oil.

9/ See attachment 3. Similar conclusions were reached more recently by the Department of Energy in its study on Energy Security, which found that a $10 oil import fee would reduce GNP by about $200 billion between 1988 and 1995. DOE, "Energy Security" (March 1987) App. D.

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Perhaps the most remarkable conclusion of the EIA study is the comparative revenue efficiency of each of the taxes, i.e. the percentage of net revenues to the federal government for each dollar of cost. The oil import fee is by far the least efficient revenue raiser, producing only $.07 of net revenue for every dollar in cost increase to the economy (7 percent efficiency). The motor gasoline excise tax is 47 percent efficient, and the oil and gas Btu tax nets 86 percent, the most efficient.

As a result of its inefficiency, the import tariff would generate only $3.7 billion in net revenue to the federal government during the period 1986-1990. The comparable motor fuels tax that produced $55 billion in gross revenue would generate $25.6 billion, the petroleum products tax $40.5 billion, and the oil and gas Btu tax $47.7 billion.

B. DRI Analysis

A recent analysis conducted by Data Resources, Inc. ("DRI") reaches an even more dramatic conclusion.[10/] DRI concludes that increased tax revenues from an oil import fee would result from its inflationary effects in the early years. However, over 5 years, a $5 import fee would cause GNP to decline by $178 billion. As a result, "output and employment losses would more than offset [any revenue increases] in later years, . . . lowering [federal] receipts by $2-$4 billion annually."[11/]

When increased federal expenditures are also included in the analysis, the total deficit reducing effect of the fee would be minimal, or negative. DRI concludes that "federal spending would rise $8-$18 billion annually because of higher government transfer payments, interest payments, and goods and services prices."

For the period 1987-1991, DRI concludes that the net effect on the deficit of a $5 import fee (in billions of dollars) is:

1987	1988	1989	1990	1991
-12B	-1B	+9B	+8B	+2B

Thus, over 5 years, a $5 oil import fee could increase the federal deficit by several billion dollars. Worse, it would deceptively appear to be a deficit reducer in its early years because of its inflationary impact, yet would exacerbate the deficit problem in later years because of its depressing effect on the economy.

On the basis of these recent EIA and DRI analyses, as well as the previous studies by Treasury and CBO, it is clear that a $5 oil import fee will not generate significant deficit reduction. The "Revenue Effects" tabulated in the Committee's description of options are misleading. That analysis is based on gross revenues; it fails to consider much of the dampening effect of the fee on the economy and the substantial increases in federal expenditures that will result.

III. Inefficiency of Oil Import Fees as a Tax

Even if the secondary impacts to the economy are not considered, and the effect on federal expenditures is excluded from the analysis, the oil import fee remains grossly inefficient. CBO's analysis of revenue options acknowledges that twice the revenue would be raised by a broad-based energy tax equivalent to approximately $1 per barrel, than from an oil import fee of $5 per barrel.[12/] Twice the revenue at one-fifth

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10/ DRI, Review of the U.S. Economy, Energy Taxes Still Not A Good Idea (March, 1987).

11/ Id. at p. 19. See attachment 3.

the cost to the economy represents a 10 fold difference in revenue efficiency.

The fundamental reason why oil import fees contribute so little to deficit reduction is their inefficiency. Oil import fees tax only oil imports, which are less than 40 percent of total U.S. oil consumption, and only 16 percent of total U.S. energy consumption.[13/] However, because oil imports are the marginal source of energy in the U.S., the price of oil imports establishes the price for domestic production of crude oil, natural gas liquids and natural gas. Therefore, consumer prices for all oil and gas products increase by approximately the amount of the fee. However, the Treasury obtains revenue only from the portion that is imported, and possibly from increased windfall profit taxes on domestic production.[14/] Accordingly, the predominant portion of the increased consumer expenditures for oil and gas flow to producers, not the federal Treasury.

IV. Trade Effects of Oil Import Fees

This Committee, and the House, have recently produced comprehensive trade legislation intended to establish a "level playing field" for U.S companies competing with foreign firms.[15/] Imposition of an oil import fee would conflict with this goal, by establishing a trade barrier for all energy intensive U.S. industries, diminishing their competitiveness in the world market.

Some proponents have suggested that oil import fees would produce significant benefits to the U.S. balance of trade. To the contrary, an oil import fee would not significantly reduce the U.S. trade deficit because it would create serious trade problems for many U.S. industries. In 1986, petroleum imports accounted for approximately $30.1 billion of the U.S. trade deficit of $147.7 billion. Oil import payments were $75.6 billion in 1981; since that year, the petroleum component of the U.S import bill has declined from 28.9 percent to 9.2 percent. Clearly, the massive increase in the U.S. trade deficit has not been caused by oil imports.

If oil import fees are enacted, the U.S. would impose on its domestic industries energy prices that are significantly higher than those paid by the rest of the industrial world. This differential will place a severe competitive burden on all energy intensive U.S. industries, such as chemicals, agriculture, steel, wood and paper products, mining and plastics. These industries will be subject to greater import penetration, and will have much greater difficulty competing in foreign markets.

The competitive damage to these industries would likely offset any modest reduction in the trade deficit resulting from decreased oil imports. These industries will help to restore a positive U.S. balance of trade. Handicapping them with an oil import fee would significantly diminish the chances that H.R. 3 will successfully correct existing trade imbalances.

V. Oil Import Fees Would Provide a Windfall For Canadian Gas Producers

Ironically, foreign as well as domestic producers of natural gas would reap a windfall from oil import fees. In the past year, the U.S. imported approximately .8 Tcf of natural gas, primarily from Canada. These imports are priced on the basis of competing fuels, and no tariff is imposed. Accordingly, an oil import fee of $5 per barrel could yield an increase in the price of gas imports of approximately $.83/MMBtu. Based on the past

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13/ Petroleum accounts for about 43 percent of total U.S. energy consumption. See, e.g., DOE/EIA Monthly Energy Review (January 1987) at pp. 23-29.

14/ Windfall profit taxes do not apply to most production below $20 per barrel.

15/ H.R. 3, Trade and International Economic Policy Reform Act of 1987.

year's import volume, foreign gas producers would receive about $750 million in windfall revenues if a $5 import fee were imposed.

It is not likely that the Congress would be interested in providing foreign gas producers with such a windfall. Thus, it seems clear that no fee on imported oil would even be considered unless an equivalent fee were imposed on imported gas. However, such an inequitable situation exists today. Most imported crude oil is taxed at the rate of $.105 per barrel, and an additional tariff of $.117 per barrel is imposed to finance Superfund; imported gas enters duty free. This anomoly should be corrected. Imposition of an equivalent tariff on imported natural gas would yield approximately $30 million per year to the Treasury. Revenues would be greater if, as projected, gas imports increase in the future.

VI. An Efficient and Fair Energy Tax Must Tax All Energy Use

As the foregoing documents, as much as ten times the revenue can be raised with equal consumer impact if an energy tax is broad-based. Some contend that a broad-based energy tax is too complex, or too difficult to administer. It need not be.

Imposition of an ad valorem energy tax would not be unduly difficult. It could be included in the cost of energy to gas and electric utilities, and petroleum refiners and importers, as a percentage of their cost of fuel purchased. While a large number of taxpaying entities would be involved, most are already familiar with federal and state excise taxes.

Taxing the cost of energy equally on an ad valorem basis guarantees fairness to all energy consumers, and regions. All consumers would pay the same energy tax, whether they consume heating oil, natural gas, electricity, motor gasoline, aviation fuel, or any other energy product. If appropriate, exemptions for particular forms of energy, or particular consumers, could be included.

Most significantly, such an across-the-board energy tax would generate approximately 10 times the gross revenue to the Treasury as an equivalent tax on imported oil, and have much less adverse impact on the economy. Thus, it could raise needed revenues at relatively low levels of tax. It would also accomplish its objective -- raising revenue -- fairly, by taxing all energy consumers equally. If taxes on the energy sector are to be included in the FY 1988 Budget Reconciliation, only this form of energy tax should be considered by the Committee.

Conclusion

Oil import fees should not be included in the Committee's recommended revenues for meeting the targets of the FY 1988 Budget Resolution. Import fees should not be rejected solely because they are unfair to one region and one group of consumers; they should be rejected because they would generate little or no revenue and would impose a significant burden on the economy. In addition, they would hamper the ability of energy intensive industries to compete in world markets. If any energy tax is recommended, it should be a broad-based ad valorem tax on all energy sources. This would raise significant revenues at relatively low economic cost, and would be fair to all consumers.

Thank you.

DEPARTMENT OF THE TREASURY
CHAPTER II: ECONOMIC
IMPACT ON THE UNITED STATES

Attachment 1

Addendum

Economic Impact of a $25 Per Barrel Price of Oil

The preceding analysis is based on a $13 drop in the world market price of oil to $20 per barrel. If the price of oil drops only $8 to $25 a barrel, the economic impact obviously would be smaller than that estimated for an oil price of $20 per barrel. Using an analytic framework that parallels the preceding one, a price reduction of $8 per barrel would yield a transfer of about $15.6 billion from foreign oil producers to U.S. users of oil. Part of this $15.6 billion would be spent on additional oil imports, i.e., about 1 million barrels per day or $10.4 billion, leaving $5.2 billion available for the purchase of domestic goods and services. This $5.2 billion would be an increment of about .15 percent to nominal GNP unless offset by reduced purchases from the United States by oil producing nations.

In addition to the transfer of income from foreign producers, an $8 reduction in the price of oil would transfer $30 billion of income from domestic producers of crude oil to domestic users. In total, the approximately $35.2 billion that would be available to the nonoil sectors of the economy would represent slightly less than 1 percent of GNP at the level two years from now.

The direct effect of the drop in oil prices on the overall level of prices for domestically purchased goods and services would be to lower it by about 1 percentage point or slightly more than the increase in real domestic output. To this would be added perhaps another 0.6 to 0.7 percentage points for the effects of lower oil prices on the costs of producing other goods and services. Finally, secondary effects through escalator clauses, etc., might tend to widen this further, but these effects would tend to be undone as real nonoil production expanded toward capacity.

If the price of oil drops $8 a barrel, leading to a real GNP increase of about 1 percent, there could be a modest reduction in the unemployment rate of perhaps 0.4 to 0.5 percentage points. This would translate into higher employment by about 400,000 to 500,000 persons.

The effect of an $8 or 24 percent decline in oil prices would reduce the budget deficit by approximately $4 billion to $5.5 billion. This deficit reduction would be the net effect of a reduction in tax receipts of $4.7 billion to $6 billion and a reduction in outlays of about $10 billion.

ECONOMIC AND BUDGETARY CONSEQUENCES OF AN OIL PRICE DECLINE -- A PRELIMINARY ANALYSIS -- MARCH 1983

Attachment 2

CONGRESSIONAL BUDGET OFFICE

TABLE 3. BUDGET DEFICIT EFFECTS OF ALTERNATIVE LOWER OIL PRICE PATH
(Changes from baseline projections, by fiscal year, in billions of dollars)

	1984	1985	1986	1987	1988	Cumulative Five-Year Total
Oil Prices $4 Lower:						
Windfall profit tax (gross)	1	1	1	1	1	5
Other revenues	-4	-6	-7	-11	-14	-44
Indexed benefits and unemployment insurance	*	-2	-2	-3	-3	-10
Interest costs	-1	-2	-2	-3	-5	-13
Other outlays	-1	-1	-1	-1	-1	-5
Total Deficit Effects	-6	-10	-12	-17	-22	-66
Oil Prices $6 Lower:						
Windfall profit tax (gross)	3	3	3	3	3	15
Other revenues	-3	-5	-5	-10	-13	-36
Indexed benefits and unemployment insurance	-2	-4	-5	-6	-7	-25
Interest costs	-4	-5	-7	-7	-9	-32
Other outlays	-1	-3	-4	-4	-5	-17
Total Deficit Effects	-6	-14	-17	-23	-31	-91
Oil Prices $8 Lower:						
Windfall profit tax (gross)	6	5	5	4	4	24
Other revenues	-4	-5	-6	-12	-17	-44
Indexed benefits and unemployment insurance	-2	-6	-8	-10	-10	-36
Interest costs	-5	-7	-9	-11	-13	-45
Other outlays	-2	-4	-6	-7	-8	-27
Total Deficit Effects	-7	-17	-24	-36	-45	-130
CBO Baseline Deficit	201	211	227	247	268	1,152
Oil Prices $4 Lower	195	201	215	229	246	1,086
Oil Prices $6 Lower	194	197	209	222	236	1,059
Oil Prices $8 Lower	194	194	203	211	222	1,023

* Less than $500 million.

THE IMPACT OF LOWER WORLD OIL PRICES
AND ALTERNATIVE ENERGY TAX PROPOSALS
ON THE U.S. ECONOMY

DEPARTMENT OF ENERGY, ENERGY INFORMATION
ADMINISTRATION

Table ES-2. Summary of Economic Impacts of Energy Taxes

	No-Tax Base Case	Change From Base			
		Import Tariff	Motor Gasoline	All Petroleum Products	Oil & Gas Btu
Real GNP Growth[1] (Compound annual rate of change 1985-1990)	3.17%	3.08%	3.12%	3.14%	3.15%
Change in Inflation Rate (CPI) (5-year average, 1986-1990)	--	1.4	0.4	0.4	0.3
Number of Jobs Lost (Thousands)	--	434	194	133	90

[1]Levels, not change from base case.

Table ES-3. Federal Budget Impacts of Alternative Energy Taxes, 1986-1990 Five-Year Totals (Billion Nominal Dollars)

	Change From Base			
	Import Tariff	Motor Gasoline	All Petroleum Products	Oil & Gas Btu
Designed Tax Receipts	52.0	54.5	55.1	55.5
Actual Tax Receipts[1]	48.8	35.8	51.0	55.8
Offsetting Federal Expenses	45.1	10.2	10.5	8.2
5-Year Reduction in Deficits[2]	3.7	25.6	40.5	47.7
Tax Efficiency (Percent)	7.0	47.0	74.0	86.0

[1]Actual Tax Receipts reflect the revenue losses due to changes in inflation, reduced personal income, and other secondary economic effects; they can be significantly less than the Designed (first order) Tax Receipts.

[2]Conclusions about the performance of the economy and the Federal deficit are based on simulation results using the DRI Quarterly Model of the U. S. Economy, and are not related in any way to Administration or other forecasts which embody different baseline assumptions about growth, inflation, exchange rates, and proposed policies.

THE IMPACT OF LOWER WORLD OIL PRICES
AND ALTERNATIVE ENERGY TAX PROPOSALS
ON THE U.S. ECONOMY

DEPARTMENT OF ENERGY, ENERGY INFORMATION
ADMINISTRATION

Table 16. Federal Budget Impacts of Alternative Energy Taxes, 1986-1990 Five-Year Totals (Billion Current Dollars)[1]

	Tax Base Case	Change From Base			
		Import Tariff	Motor Gasoline	All Petroleum Products	Oil & Gas Btu
Direct Energy Tax Revenue[2]	60.5	45.3	54.5	55.1	55.5
Windfall Profit Tax	2.1	6.7	0	0	0
Sub Total	62.6	52.0	54.5	55.1	55.5
Other Federal Revenues	4940	-3.2	-18.7	-4.1	.3
Total Federal Revenues	5003	48.8	35.8	51.0	55.8
Total Federal Expenditures	5587	45.1	10.2	10.5	8.2
5-Year Reduction in Deficit	-584	3.7	25.6	40.5	47.6

[1]Conclusions about the performance of the economy and the Federal deficit are based on simulation results using the DRI Quarterly Model of the U.S. Economy, and are not related in any way to Administration or other forecasts. which may embody different baseline assumptions about growth inflation, exchange rates, and proposed policies.

[2]Includes current Federal taxes on gasoline and diesel fuels

[3]Oil prices in the tax base case are assumed to be constant at $20 per barrel (1985 dollars).

Note: Non-energy receipts and expenditures were estimated using the DRI macroeconomic model, and thus include feed back effects on the economy. Modifications were made to the DRI estimates for corporate tax receipts, where off-line estimates were made for oil and non-oil profit taxes separately. Another modification assumed no change in Federal interest payments from the baseline across all cases.

Energy Taxes: Still Not a Good Idea

Table 1
Effects of a $5 per Barrel Oil Import Fee

	Changes Relative to Base Case				
	1987	1988	1989	1990	1991
	(Billions of dollars)				
Energy Tax Levy	11	10	11	12	13
Consumers Energy Bill	11	14	14	13	11
Price Effects					
	(Percentage change)				
Crude Oil Acquisition Price	29.8	28.4	27.0	25.0	22.7
(Dollars per barrel)	5	5	5	5	5
Retail Gasoline Price'	12.5	12.3	11.4	10.0	8.6
(Cents per gallon)	12	12	12	11	10
Producer Prices					
Fuels, Related Products & Power	15.4	17.7	17.1	15.8	14.3
Refined Petroleum Products	21.6	23.0	21.4	19.2	17.1
Gas Fuels	18.6	22.2	20.7	18.5	16.5
Coal	1.6	4.4	6.6	6.7	6.1
Electric Power	2.8	6.1	7.2	7.4	6.8
Industrial Commodities	2.9	3.6	3.4	3.1	2.7
Consumer Price Index	1.0	1.5	1.7	1.7	1.6
Consumer Energy Prices	8.3	9.6	9.3	8.4	7.4
Macroeconomic Impacts					
Real GNP (Billions of 1982 dollars)	-7	-28	-52	-51	-41
	(Percentage change)				
Real GNP	-0.2	-0.7	-1.3	-1.2	-1.0
Consumption	-0.6	-1.0	-1.3	-1.3	-1.2
Energy	-2.2	-2.3	-2.3	-2.3	-2.3
Residential Investment	-1.0	-1.8	-2.2	-1.1	0.1
Business Fixed Investment	0.4	-0.5	-2.5	-2.6	-1.7
Exports	-0.2	-1.0	-2.2	-2.6	-2.4
Imports	-1.6	-2.7	-3.5	-3.6	-3.2
Real Disposable Income	-0.5	-0.8	-1.2	-1.3	-1.2
Industrial Production	-0.6	-2.2	-3.5	-3.4	-2.8
Treasury Bill Rate (Basis points)	17	28	22	10	-2
Housing Starts (Thousands of units)	-30	-52	-50	-14	17
Employment	-0.1	-0.4	-0.8	-0.9	-0.8
(Thousands of persons)	-90	-418	-897	-989	-858
Oil Imports (Billion barrels)	-0.2	-0.4	-0.5	-0.5	-0.6
Current Account Balance (Billions of dollars)	7	11	11	8	6
Government Budget Impacts					
	(Billions of dollars)				
Federal Government					
Offsetting Tax Changes	7	2	-4	-2	0
Total Revenues	18	13	8	10	12
Expenditure Changes	6	12	17	18	14
Federal Deficit	-12	-1	9	8	2
State & Local Government Deficit	1	3	3	0	-2
Total Government Deficit	-11	2	12	8	0

Mr. RANGEL. Thank you, Mr. Buckley. I assume Mr. Downey does not have a statement.

Mr. DOWNEY. No statement.

Mr. RANGEL. We will now hear from Mr. Archer.

STATEMENT OF JOHN ARCHER, MANAGING DIRECTOR, GOVERNMENT AFFAIRS, AMERICAN AUTOMOBILE ASSOCIATION

Mr. ARCHER. Thank you, Mr. Chairman. The American Automobile Association, serving more than 27.7 million members, appreciates the opportunity to offer testimony today.

Obviously, it probably comes as no shock to anyone that AAA believes that increasing the gasoline tax is the wrong way to reduce the Federal budget deficit.

But we sincerely believe that our six arguments against singling out the motorists to balance the budget are compelling.

First and foremost, the American people are against it. According to the latest Washington Post/ABC News Poll, 73 percent disapprove of raising taxes on gasoline to balance the Federal budget.

Second, a gas tax increase would be bad economics. Especially troubling is the Wharton Econometrics finding that a 10-percent increase in the gasoline tax would reduce employment by 80,000 next year and 180,000 by 1990.

Third, the poor, as a class, would be hurt worse by such a tax, because they drive older, less fuel efficient vehicles. We cannot believe that many Members of Congress would want to hit the working poor with a large new tax burden less than a year after approving a tax reform law that was touted as removing them entirely from the Federal tax rolls.

Fourth, regional inequities would be created. Why should a resident of Wyoming pay more than twice as much as a resident of the District of Columbia to cut the Federal deficit solely because the person from Wyoming must drive longer distances?

Fifth, taxing gasoline for deficit reduction would seriously erode the public support for the very successful pay as you go Federal-State highway program. States will be hard pressed to justify increases in their transportation related taxes, if their Federal counterparts usurp this important taxing mechanism.

And, finally, the tourism industry, one of the top three employers in 80 percent of the States, would be adversely affected. Tourism is very sensitive to the price of gasoline because approximately four-fifths of vacation travel is done by private vehicles run on gasoline.

The Wharton study projected that 1988 miles traveled per vehicle would be reduced approximately three percent with a ten cent tax increase. That reduction grows to almost 8 percent with a 30-cent-tax rise at least in the near term.

Unfortunately, we are afraid the 30-cent-tax hike may become a real possibility over the next 3 years. With the constant pressure for more and more revenues, the AAA is afraid that the 10 cent gas tax increase may, in fact, become only a first installment in a march of dimes, if the precedent is established to use gasoline taxes to fund the deficit.

Of course, traditional gasoline taxes to fund highway construction are also regressive and they do have differing regional impacts, but they are justifiable on a user fee basis; namely, the more you drive, the more you pay. What could be fairer than that? But this justification collapses completely for gasoline tax not earmarked for economically beneficial road construction.

Obviously the AAA believes the committee should look elsewhere for needed revenues in the motor fuels area.

In our view, the committee should seriously look at eliminating the gasohol exemption and also at curtailing diesel fuel tax evasion.

Complete elimination of ethanol subsidies may not be desirable and also may not even be politically feasible. But the committee should, at least in our view, look at eliminating the gasohol exemption while retaining the 60 cent per gallon tax credit, possibly in a modified form designed to limit its benefit to small U.S. firms.

The principal recipients of tax benefits under the gasohol exemption today, albeit indirect recipients, are alcohol importers and larger domestic firms. They hardly fall into the category of struggling small businesses attempting to gain U.S. energy independence.

Finally, we also strongly believe that diesel fuel tax evasion should be combatted by any means possible. Before raising Federal fuel taxes, the Government should insure that all taxes imposed are collected. Simply raising taxes makes illegal activities even more profitable. Thank you for listening to our concerns.

Mr. RANGEL. Thank you for your contribution. Without objection, your statement will be placed in the record in its entirety.

[The statement and exhibits of Mr. Archer follow. Additional exhibits have been retained in committee files.]

87-665 0 - 89 - 20

American Automobile Association

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TESTIMONY OF

JOHN ARCHER

MANAGING DIRECTOR, GOVERNMENT AFFAIRS

AMERICAN AUTOMOBILE ASSOCIATION

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON WAYS AND MEANS

OPPOSING A NEW FEDERAL GASOLINE TAX

AND

SUPPORTING ELIMINATION OF THE GASOHOL EXEMPTION AND

MAXIMUM CURTAILMENT OF DIESEL FUEL TAX EVASION

JULY 9, 1987

Mr. Chairman, members of the committee, I am pleased to be here today. I am John Archer, managing director of Government Affairs for the American Automobile Association.

AAA is a federation of automobile clubs serving more than 27.7 million dues-paying members. AAA's members purchase nearly 20 percent of the 100 billion gallons of gasoline sold annually. For this and other reasons, AAA is strongly opposed to proposals to impose a new federal tax on gasoline or oil to reduce the federal deficit. Singling out the motorist to balance the budget at the gas pump is not only unfair but unwise.

The American People Strongly Oppose A Gasoline Tax Increase

The American people oppose a federal gas tax increase for deficit reduction, as indicated by the latest Washington Post-ABC News Poll, conducted June 25 to June 29. The nationwide telephone poll of 1,506 people found that 73 percent of those polled disapprove of raising taxes on gasoline to balance the federal budget (27 percent approved).

Negative Economic Impact

Because of the continuing legislative interest in further taxing gasoline, AAA recently commissioned Wharton Econometric Forecasting Associates to study the economic impacts of major excise tax proposals.

The study concluded that the near-term costs of such a gasoline tax are exceedingly negative. Thousands of people would be put out of work, consumer prices in general would rise, and the poor would be hurt disproportionately. People who come from the South and West--many of whom have already suffered from the recent downturn in oil prices--on average must travel greater distances by personal vehicles and therefore pay even more of this tax.

Specifically, the study found that adding 10 cents to the cost of a gallon of gasoline would produce the following negative economic impacts:

-- The Gross National Product would be reduced by nearly $10 billion in the first year alone;
-- Automobile production would fall by 1.3 percent;
-- Housing construction would drop 0.9 percent;
-- 80,000 persons would be out of work next year;
-- 180,000 would be out of work by 1990;
-- Petroleum refinery output would decline by 1.2 percent;
-- Income tax revenues would decline by nearly $1 billion annually;
-- Personal savings would decline by nearly 3 percent;
-- The Consumer Price Index would rise by 0.3 percent.

Adding 30 cents more to the cost of gasoline--as would one legislative proposal--would virtually triple these consequences. Most important is the study's finding that 225,000 persons would be put out of work next year and 525,000 would be out of work by 1990.

The study found the following secondary impacts worthy of note:

-- Welfare payments by government agencies for unemployment and food stamps would increase;
-- Payments of U.S. industries for wages and salaries would fall, multiplying the impact on national income.

The study is included with this testimony, along with a letter to Representative Glenn Anderson, Chairman of the House Surface Transportation Subcommittee, wherein Dr. Mark French, the author of the study, further discusses the conclusions of his study, along with other possible options he chose to examine.

The highly negative economic effects of a new federal excise tax on gasoline also were emphasized in the Energy Department's recent Energy Security report. That report states that a new gasoline tax would be inflationary, discriminate against low income groups, reduce tax revenues in other categories, and increase unemployment. It concluded that a gasoline tax "is not a cost effective way to increase energy security," and that the "macroeconomic loss is estimated to (be) over 100 times as high as the estimated energy security benefits."

Income Distortions

A gasoline tax increase for deficit reduction would place an undue burden on lower income families. According to the U.S. Census Bureau, nearly 78 percent of Americans earning less than $10,000 drive to work. Families that earn less than $5,000 annually pay nearly 8 times more of their available income in gasoline taxes than those families earning in excess of $50,000 (see Exhibit I). According to the Congressional Budget Office, the lower income group pays more than 1.6 percent of their income to gasoline excise taxes, while the high income group pays only 0.2 percent of their income.

This large gap in tax apportionment demonstrates the very substantial burden gasoline taxes have on the poor. An increase in this tax would seriously exacerbate this regressive effect.

Of course, traditional gasoline taxes to fund highway construction are also regressive (and have differing regional impacts), but they are justifiable on a user fee basis. The more you drive and therefore derive benefit from the nation's road structure, the more you pay--what could be fairer than that? However, this justification collapses completely for a gasoline tax not earmarked for economically beneficial road construction or rehabilitation.

Moreover, even a minor increase in gasoline taxes would counteract the tax benefits derived by the working poor from the Tax Reform Act of 1986. Calculations by Peat Marwick Main & Co. indicate that the 1986 Tax Reform Act provided $414 million in tax reduction for income groups earning less than $10,000 annually. However, a 1-cent gasoline tax increase would reduce this benefit by $99 million, and a 4-cent increase would largely negate this benefit, while a 12-cent gasoline tax would triple the harm to this low-income group.

We cannot believe that many members of Congress want to hit the poor with a huge tax burden less than a year after approving the tax reform law that was touted as removing them entirely from the federal tax rolls. Such an abrupt turnaround would be unfair.

Geographic Distortions

Consumers in some parts of the nation would bear a disproportionate brunt of any increase in gasoline tax payments. For example, in the eastern United States, consumers use much less gasoline than must their counterparts in western and many southern states. A comparison of the average annual fuel consumption per licensed driver in the District of Columbia (394 gallons), New York (568 gallons), and Rhode Island (574 gallons) with that of Wyoming (882 gallons), Tennessee (788 gallons), or Oklahoma (754 gallons), provides an indication of the vast differences in distances traveled and gasoline purchased from region to region (see Exhibit II).

Why should a resident of Wyoming pay more than twice as much as a resident of the District of Columbia to cut the federal deficit solely because the person from Wyoming must drive longer distances? In both cases, the money raised would be diverted to non-highway purposes. So drivers in all of these areas would gain no direct benefit from the new tax. The table attached to this testimony (Exhibit III) shows how the various tax proposals would affect motorists in each of the states.

Jeopardizing Highways

The imposition of a federal gasoline tax for deficit reduction also threatens the future ability of states to raise user fuel taxes for road construction and repair.

All but one cent of the current 9-cent federal excise tax on gasoline is dedicated to building and improving the nation's federal/state highway system. This system is the envy of the world, as is the mechanism that has been used to finance it.

To tax gasoline for non-highway purposes would seriously erode the public's support for the successful pay-as-you-go federal/state highway program. It would severely hamper the ability of states to raise their own motor fuel taxes to match federal dollars, as well as jeopardize public support for strictly local projects.

To meet burgeoning highway needs, eight states have raised fuel taxes this year, and 14 more are considering doing so. But state legislators would be hard pressed to justify further increases in their transportation-related taxes if their federal counterparts usurp this role. If that happens, the federal government could quickly find itself obligated to bear the cost of all future transportation projects because states would be unable or unwilling to do so.

A Low Blow to Tourism

It is painfully ironic that only weeks after the country celebrated National Tourism Week, Congress is seriously considering a major new gasoline tax which could have severe consequences for the tourism industry. After all, approximately 80 percent of vacation travel in the U.S. is conducted by private vehicles which would have to pay such a tax.

National Tourism Week's slogan--Tourism Works for America--is a clear statement about its enormous contribution to the U.S. economy.

Tourism is one of the top three employers in 80 percent of the states. Auto travel, including by car, truck, RV, and motorcycle, represents the primary mode of transportation for all travel away from home in the U.S. According to The 1986-87 Economic Review of Travel in America, published by the U.S. Travel Data Center, "(P)ersonal motor vehicle travel is particularly sensitive to...rapid price inflation." Wide fluctuations in gasoline prices, whether caused by turmoil in the Persian Gulf or by federal tax policy, would have a major impact on vehicle travel and tourism in general.

In Wharton's study on the effects of gasoline taxes, it found that "...every one percent increase in real gasoline price drives down simulated car travel by one-half of a percent. In addition, changes in real income also affect simulated miles traveled. Together, these price and income effects reduced simulated 1988 miles traveled per vehicle by just under 3 percent with a 10-cent tax increase. The fall was closer to 8 percent with a 30-cent tax rise."

Unfortunately, a 30-cent tax hike may be a real possibility over the next three-year budget cycle if a gasoline tax increase is enacted this year. The budget committees have concluded that they need more than 60 billion dollars in new taxes in the next three years. Thus the 10-cent gas tax increase now being considered could even become only a first installment on future increases, if the precedent is established to use gasoline taxes to fund the deficit.

With another rising trend in the cost of oil, the last thing the American public needs is a federal gasoline tax increase, let alone several such tax increases over the next few years.

Revenue Increase Options

Of course, there are other ways to raise revenues instead of raising the excise tax on gasoline. We believe that at least two revenue enhancers in the motor fuels area should be seriously examined.

The first is the possible elimination of the gasohol exemption from the federal gasoline tax. A vehicle using gasohol is presently exempted from 6-cents of the 9-cents-per-gallon federal gasoline tax. The Federal Highway Administration estimates that the federal gasohol tax exemption will result in a loss to the federal government of some $450 million in 1987 and in four years will represent a loss of more than

$500 million annually. This exemption violates the basic tenet of highway finance; namely that if you use the roads, you should pay your fair share of road construction and repair.

If the committee feels ethanol should continue to be subsidized, that objective could be accomplished by eliminating the exemption but retaining the blender tax credit of 60-cents-per-gallon of alcohol. The tax credit to subsidize ethanol producers could be limited to a maximum amount per producer. Termination of the exemption and modification of the credit would reduce the cost of alcohol subsidies, end current subsidies to foreign production, reduce the size of the subsidies now given to a few large domestic producers, but at the same time continue a 60-cent-per-gallon subsidy for small ethanol blenders. Large domestic producers and alcohol importers, which are the principal (although indirect) recipients of the tax benefits of the gasohol exemption, hardly fall into the category of struggling U.S. small businesses attempting to gain U.S. energy independence.

Presently, according to FHWA, government subsidies for gasohol exceed the selling price of the product by approximately 15 percent. Under the current subsidy structure this industry no longer makes economic sense. Encouraging inefficient producers by oversubsidizing their product only ensures greater U.S. tax revenue losses in the future.

Another area that should be considered is diesel fuel tax evasion. The Federal Highway Administration estimates that the loss to the federal government could be in the neighborhood of $500 million annually. According to FHWA, "there is ample evidence that widespread evasion of payment of the diesel motor fuel taxes is continuing..."

It is time that this callous disregard for paying necessary federal excise taxes be stopped. This money is owed to the federal government and it should be paid and collected. Simply by moving the point of tax incidence and collection from the fuel pump to the jobber or distributor level could reduce the number of tax collection points by tens of thousands. This remedy could help pinpoint tax responsibility and reduce the number of tax audits needed to verify tax collection.

Evasion of diesel tax is not a new issue to come before this committee. The hearing on "Alternatives to the Heavy Vehicle Use Tax" on February 23, 1984, "...identified two major areas in which evasion can...occur." First "...substitution of home heating oil for diesel fuel, thereby avoiding the tax increase." Second, "...exemptions for agricultural uses of diesel...offers another major potential for evasion."

Your 1984 hearing [p. 134 "Alternatives to the Heavy Vehicle Use Tax" Hearing before the Committee on Ways and Means, House of Representatives, Serial 98-65, Feb. 1984.] also cites the significant enhancement of revenue collections in Canada by "...adding color to fuel in order to demonstrate the difference between fuel which was eligible for diesel over-the-road trucks, as distinct from other kinds of diesel fuel uses." In fact, in your hearing a state official testified of personal

knowledge of a common practice of substituting No. 2 diesel (home heating oil) for No. 1 diesel fuel during the warm weather months.

Before even considering an increase in federal fuel taxes, the government should ensure that all taxes imposed are collected. Simply raising taxes makes illegal activities even more profitable.

Thank you again for listening to our concerns.

JA/lb

Exhibit I

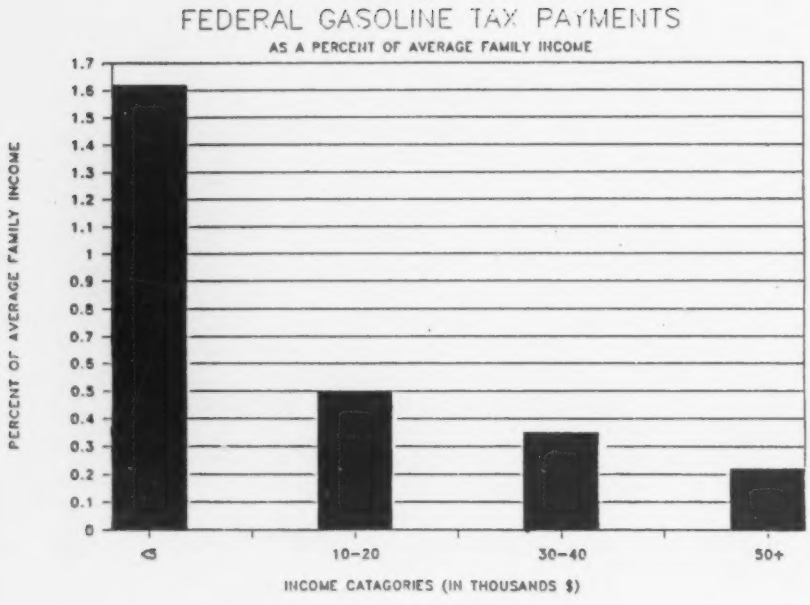
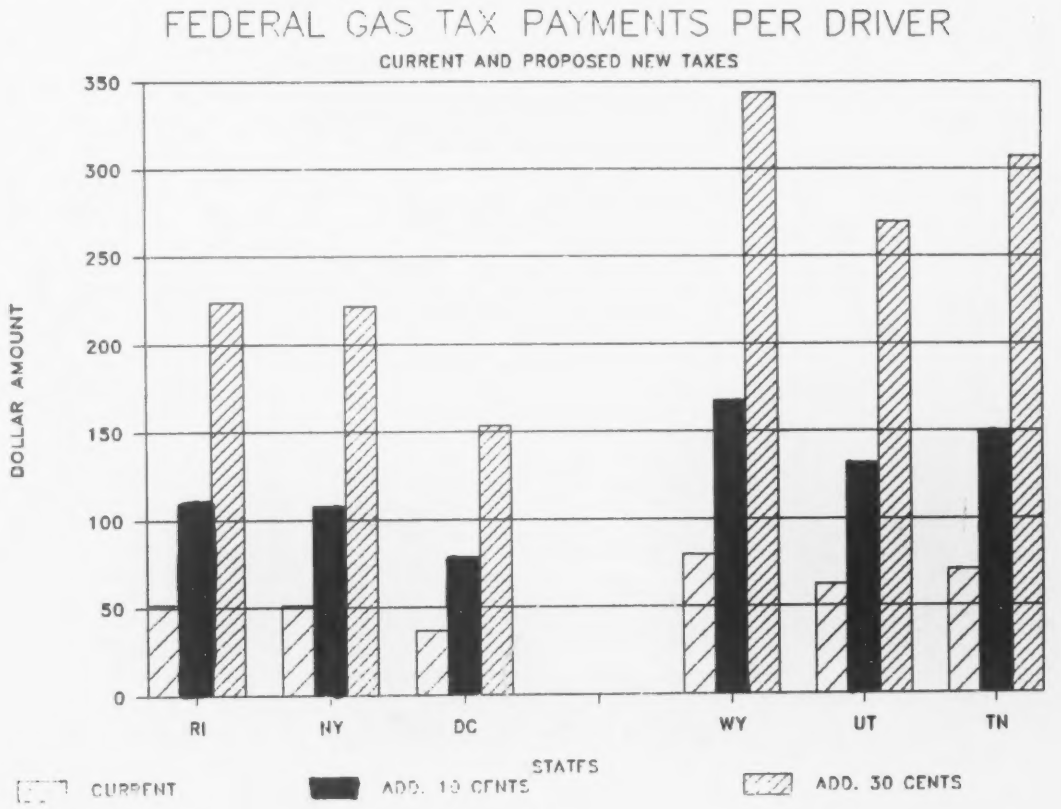

FEDERAL GASOLINE TAX PAYMENTS
AS A PERCENT OF AVERAGE FAMILY INCOME
PERCENT OF AVERAGE FAMILY INCOME
1.7
1.6
1.5
1.4
1.3
1.2
1.1
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
<5
10-20
30-40
50+
INCOME CATAGORIES (IN THOUSANDS $)

Exhibit II


FEDERAL GAS TAX PAYMENTS PER DRIVER
CURRENT AND PROPOSED NEW TAXES
DOLLAR AMOUNT
350
300
250
200
150
100
50
0
RI
NY
DC
WY
UT
TN
STATES
CURRENT
ADD. 10 CENTS
ADD. 30 CENTS

ANALYSIS OF PROPOSED FEDERAL TAXES ON GASOLINE FOR DEFICIT REDUCTION
BASED ON 1985 GASOLINE USAGE AND LICENSING DATA (1)
PREPARED BY AMERICAN AUTOMOBILE ASSOCIATION, GOVT. AFFAIRS

STATE	TOTAL LICENSED DRIVERS	ANNUAL GASOLINE USE(2)	ANNUAL GAS USE (3) PER DRIVER	TOTAL STATE GAS TAX	TOTAL STATE & FED. TAX	TOTAL W/ 9 CENTS ADDED	DIFFER.	TOTAL W/ 10 CENTS ADDED	DIFFER.	TOTAL W/ 12 CENTS ADDED	DIFFER.	TOTAL W/ 30 CENTS ADDED	DIFFER.	STATE
AL	2,461,559	1,773,542	720	$93.66	$158.51	$223.35	$64.84	$230.56	$72.05	$244.97	$86.46	$374.66	$216.15	AL
AK	300,000	202,189	677	54.19	115.15	176.11	60.96	182.88	67.73	196.43	81.28	318.35	203.20	AK
AZ	2,324,591	1,495,801	643	102.95	160.87	218.78	57.91	225.21	64.25	238.08	77.22	353.81	193.04	AZ
AR	1,723,753	1,067,133	619	83.58	139.29	195.01	55.72	201.20	61.91	213.58	74.29	325.01	185.72	AR
CA	17,444,640	10,971,711	629	58.61	113.21	169.82	56.61	176.10	62.89	188.68	75.47	301.89	188.68	CA
CO	2,284,364	1,471,482	644	115.95	173.92	231.90	57.97	238.34	64.42	251.22	77.30	367.17	193.25	CO
CT	2,314,612	1,286,240	556	94.47	144.48	194.50	50.01	200.05	55.57	211.17	66.68	311.19	166.71	CT
DE	447,937	309,601	691	89.85	152.06	214.26	62.21	221.17	69.12	235.00	82.94	359.41	207.35	DE
DC	384,736	151,441	394	61.01	96.44	131.86	35.43	135.80	39.36	143.67	47.23	214.52	118.09	DC
FL	8,016,239	4,982,050	621	60.28	116.22	172.15	55.93	178.37	62.15	190.80	74.58	302.67	186.45	FL
GA	3,910,454	2,000,008	767	87.54	126.58	195.62	69.05	203.30	76.72	218.65	92.06	356.74	230.15	GA
HI	593,952	310,131	522	57.44	104.43	151.42	46.99	156.64	52.21	167.09	62.66	261.07	156.64	HI
ID	692,404	409,128	585	84.84	137.50	190.16	52.66	196.01	58.51	207.71	70.21	313.03	175.53	ID
IL	6,949,622	4,594,229	661	85.94	145.44	204.93	59.50	211.54	66.11	224.77	79.33	343.76	198.32	IL
IN	3,597,585	2,377,364	661	92.52	151.99	211.46	59.47	218.07	66.08	231.29	79.30	350.24	198.25	IN
IA	1,900,998	1,225,615	645	103.16	161.16	219.21	58.02	225.65	64.47	238.55	77.37	354.60	193.42	IA
KS	1,655,820	1,131,990	684	75.20	136.72	198.26	61.53	205.09	68.36	218.77	82.04	341.82	205.09	KS
KY	2,248,381	1,602,540	713	106.91	171.06	235.21	64.15	242.34	71.28	256.59	85.53	384.89	213.83	KY
LA	2,755,943	1,983,728	720	115.17	179.95	244.73	64.78	251.93	71.98	266.33	86.38	395.89	215.94	LA
ME	803,830	498,411	620	86.81	142.61	198.41	55.80	204.61	62.00	217.02	74.41	328.62	186.01	ME
MD	2,907,494	1,914,815	659	121.84	181.11	240.38	59.27	246.97	65.86	260.14	79.03	378.68	197.57	MD
MA	3,792,074	2,271,738	599	65.90	119.82	173.73	53.92	179.72	59.91	191.70	71.89	299.54	179.72	MA
MI	6,254,116	3,791,074	606	90.93	145.48	200.04	54.56	206.10	60.62	218.22	72.74	327.33	181.85	MI
MN	2,473,073	1,777,542	719	142.10	186.68	251.57	64.89	258.75	72.08	273.13	86.25	402.50	215.63	MN
MS	1,810,847	1,115,067	616	55.42	110.84	166.26	55.42	172.42	61.58	184.73	73.89	295.57	184.73	MS
MO	3,393,353	2,472,657	729	51.01	116.59	182.17	65.58	189.46	72.87	204.03	87.44	335.19	218.60	MO
MT	582,085	391,164	672	114.24	174.72	235.20	60.48	241.92	67.20	255.36	80.64	376.32	201.60	MT
NE	1,089,797	670,067	615	105.14	160.48	215.81	55.34	221.96	61.48	234.26	73.78	344.93	184.48	NE
NV	699,077	473,868	678	88.14	149.16	210.18	61.02	216.96	67.80	230.52	81.36	352.56	203.40	NV
NH	737,852	427,568	580	81.15	133.31	185.48	52.17	191.27	57.96	202.86	69.55	307.19	173.88	NH
NJ	5,793,688	3,078,522	531	42.51	90.33	138.15	47.82	143.47	53.14	154.09	63.76	249.74	159.41	NJ
NM	977,880	726,390	743	81.73	148.61	215.48	66.87	222.91	74.30	237.77	89.16	371.51	222.91	NM
NY	9,841,209	5,588,336	568	45.43	96.59	147.64	51.11	153.32	56.79	164.68	68.14	286.89	170.36	NY
NC	4,122,866	2,864,697	695	109.44	171.97	234.51	62.53	241.45	69.48	255.35	83.38	380.42	208.45	NC
ND	443,002	318,010	718	93.32	157.93	222.53	64.61	229.71	71.79	244.07	86.14	373.28	215.36	ND
OH	7,336,386	4,497,933	613	73.57	128.75	183.93	55.18	190.06	61.31	202.32	73.57	312.68	183.93	OH
OK	2,243,223	1,590,761	754	79.37	143.21	211.04	67.83	218.58	75.37	233.65	90.45	369.32	226.12	OK
OR	1,959,765	1,170,229	597	65.68	119.43	173.17	53.74	179.14	59.71	191.08	71.65	298.56	179.14	OR
PA	7,555,006	4,228,959	559	67.14	117.49	167.85	50.35	173.44	55.95	184.63	67.14	285.34	167.85	PA
RI	619,132	355,100	574	86.03	137.65	189.27	51.62	195.01	57.35	206.48	68.83	309.71	172.06	RI
SC	2,131,895	1,523,368	715	92.89	157.20	221.51	64.31	228.66	71.46	242.95	85.75	371.57	214.37	SC
SD	483,890	351,627	727	94.47	159.87	225.27	65.40	232.53	72.67	247.07	87.20	377.87	218.00	SD
TN	3,025,458	2,384,524	788	133.98	204.92	275.85	70.93	283.74	78.82	299.50	94.58	441.37	236.45	TN
TX	10,809,078	8,211,043	760	75.96	144.33	212.70	68.37	220.30	75.96	235.49	91.16	372.23	227.89	TX
UT	962,881	666,104	692	96.85	159.11	221.37	62.26	228.28	69.18	242.12	83.01	366.64	207.53	UT
VT	385,132	232,098	603	78.34	132.58	186.82	54.24	192.85	60.26	204.90	72.32	313.38	180.79	VT
VA	3,804,113	2,584,183	679	116.90	180.05	241.19	61.15	247.98	67.94	261.58	81.53	382.87	203.83	VA
WA	2,980,717	1,769,908	594	106.88	160.32	213.76	53.44	219.70	59.38	231.58	71.25	338.46	178.14	WA
WV	1,299,585	728,722	561	86.14	136.64	187.15	50.50	192.76	56.12	203.98	67.34	304.99	168.35	WV
WI	3,211,330	1,971,440	583	101.98	154.43	206.88	52.45	212.71	58.28	224.36	69.93	329.26	174.83	WI
WY	331,850	292,631	882	70.55	149.91	229.27	79.36	238.09	88.18	255.73	105.82	414.45	264.55	WY
TOTAL	156,868,277	101,280,287	646	$85.50	$144.26	$202.81	$58.55	$209.32	$65.06	$222.33	$78.07	$339.43	$195.17	TOTAL

(1) FHWA HIGHWAY STATISTICS 1985
(2) THOUSANDS OF GALLONS
(3) IN GALLONS

Mr. RANGEL. Mr. Lamm.

STATEMENT OF LESTER P. LAMM, PRESIDENT, HIGHWAY USERS FEDERATION

Mr. LAMM. I, too, will boil down my summary which I understand will be presented in the record of the committee. I am Lester Lamm, president of the Highway Users Federation. We also appreciate the opportunity to appear before the committee this morning to express our views on excise tax increase.

The Highway Users Federation is a national coalition of hundreds of businesses, industries and associations working together to make America's highway transportation system safer and more efficient.

For more than 50 years, our membership has represented the chief users of highways around the country, the main providers of highway transportation products and services and, significant to this committee, the principal payers of highway taxes around the country.

The federation has reviewed the Joint Committee print which describes the possible options which you are considering to raise revenues over the next few years.

We paid particular attention to motor fuel excise taxes. Our diverse membership may not agree on some of the individual considerations in the Joint Committee print, but I can assure you we are together on the motor fuel excise tax issue.

Others on the panel, yesterday and today, will highlight many of the problems of excise taxes in general, such as—as has been mentioned this morning, its inequity as it focuses on merely a small section of the national economy; its regressivity which is well-documented; the extent of present taxes on an essential commodity of petroleum, the state of the petroleum industry, which is having severe problems; and also the geographical inequities of the motor fuel excise tax which pit urban Americans versus rural Americans and East versus West.

I would like to concentrate for a few minutes on the impact that increasing the Federal excise tax would have on both Federal and State transportation budgets.

As you know, Mr. Chairman, this committee led the way to establishing the highway trust fund concept for financing the Federal aid highway program more than 30 years ago.

This committee also worked together to increase the motor fuel excise tax by a badly needed 5 cents per gallon in 1982 and earlier this year extended those revenues for another 5-year period.

In addition, most States, more than 30 States since 1982, have found it necessary to raise their own motor fuel excise taxes, largely because of the well-documented deterioration of the highway and bridge system.

And as we look around the country, in 1987 alone, there are 30 States which have proposed or are now considering further increases in their motor fuel excise taxes.

The point being that the Federal excise tax, if raised this year or next year to offset the deficit in the Federal budget, would preempt these badly needed State funding activities for many years to come.

And it would do so at a time when the Nation's highway system is not in good condition.

The Department of Transportation recently sent the Congress the biennial report on conditions and performance of the Nation's highway system.

This report indicates that during the last 2-year period, since the former report from DOT, traffic has increased by about 7 percent.

In fact, as I look at the numbers now, traffic today is ranging from 4½ to 6 percent higher than the same month in 1986.

And we forecast through to the end of this century, traffic will be up across the country by at least 50 percent and in some parts of the country may actually double.

To no one's surprise also, the DOT report indicates that congestion has worsened since 1983 with the percent of peak hour travel increasing from 54 percent to almost 61 percent.

Again, Mr. Chairman, members of the committee, those of us who travel on the urban interstate in this region would appreciate those numbers and agree with that.

And, further, the DOT report indicates that bridge conditions have deteriorated during the 2-year period. And, in fact, their bottom line is that just to stay even with today's transportation demands through the end of this century, the Nation, that is Federal and State Governments together, should be spending roughly $30 billion per year on highway capital investments, which is roughly 1½ times the current rate.

The true irony of the current Federal tax hike proposals is that none of the revenues would build or fix a single highway or bridge or ease congestion on any vital urban arteries, at a time when these needs are rapidly outpacing available funds.

As an illustration, Mr. Chairman, at the Federal level, the available funding, even though the revenue being collected from highway users is the same today as it was after the Surface Transportation Act was passed in 1982, we have expended roughly $2 billion less on Federal aid highway and bridge accounts than we did 2 years ago.

As to the question which the committee members have asked previous panel members, regarding Federation suggestions on how to raise additional revenues, I would repeat we have no policy on many of the provisions which were contained in the Joint Committee print.

However, there is one item which we strongly support; we believe there should be a mammoth, nationwide effort to curb evasion of current lawfully imposed motor fuel taxes.

I believe the Joint Committee print may somewhat understate the impact of this evasion. I have seen figures presented to this committee by witnesses such as the Federal Highway Administrator, Mr. Barnhart, which indicate that we may be dealing with perhaps as much as $1 billion per year.

Mr. Chairman, the Highway Users Federation is affiliated with highway user conferences in every State around the country. And every member of this committee has been hearing from your highway users back home.

Across the country, highway users are united. We feel that increasing motor fuel taxes for budget deficit purposes at the Federal

level is a bad idea and should be scrapped right now. Thank you. We would be happy to answer questions.

Mr. RANGEL. Thank you, Mr. Lamm. Without objection, your statement will be placed in the record in its entirety.

[The statement of Mr. Lamm follows:]

STATEMENT OF LESTER P. LAMM
PRESIDENT
HIGHWAY USERS FEDERATION
1776 MASSACHUSETTS AVE. N.W.
WASHINGTON, DC 20036
JULY 9, 1987

Mr. Chairman and members of the Committee on Ways and Means, I am Lester Lamm, President of the Highway Users Federation. I appreciate this opportunity to appear before the Committee to register the deep concern of the Federation and highway users in every state over proposals which would increase the Federal motor fuel tax for deficit reduction purposes.

The Highway Users Federation is a national coalition of businesses, industries, and associations, working cooperatively to make America's highway transportation system safer and more efficient. Our membership, composed of more than 400 companies and industry associations, 62 affiliated state and local highway user conferences, and more than 2000 individual business men and women, represent the chief users of highways and the main providers of highway transportation products and services.

The Federation has reviewed the Joint Committee Print which describes possible options to increase revenues, with particular attention to motor fuel excise taxes. The views of Federation members may differ on a number of other options outlined in the Committee Print, but I can assure you we are together on the fuel tax issue.

Taxing motor fuel for non-highway purposes to promote greater energy self-sufficiency overlooks the real need for a broad national energy policy which deals with all aspects of energy security. The Department of Energy's (DOE) report on Energy Security to the President in March addressed these concerns.

The DOE report also pointed out an economic inequity in Federal motor fuel tax hike for budget reduction purposes. The report notes that "low income motor fuel users spend a disproportionately high percentage of their disposable income on motor fuel." According to the Congressional Budget Office, lower income motor fuel users pay more than 1.6 percent of their income to gasoline taxes while their more affluent fellow citizens pay only 0.2 percent of their income.

Motor fuel is already one of the most heavily taxed essential commodities in the U.S. Based on national averages, total taxes on a 98.7 cents per gallon of gasoline range from 27 cents to 37 cents. This includes the 9 cents Federal tax, state and local excise taxes averaging 14.1 cents (in some states they are as high as 20 cents), and state severance taxes that range from a nickel to 15 cents a gallon. (See Exhibit I.) Indirect taxes on the production of gasoline are also passed along to the consumer.

By any standard, gasoline pays its share. Moreover, should gasoline prices drop, the taxes would become a larger and larger part of the consumer cost.

The amounts of money involved are not trivial. According to the National Association of State Budget Officers, increasing Federal motor fuel taxes by 12 cents for non-transportation spending would create a $3.4 billion shortfall in the Highway Trust Fund over the next five years -- the life of the current law. Diminished fuel consumption would cause an additional $4 billion to be irrevocably lost to state treasuries over the same period.

States traditionally look to motor fuel taxes for essential highway program funding. Levying a higher federal gasoline tax hike strictly to help reduce the deficit could have the effect of preempting the states from further state-level motor fuel tax increases, notwithstanding substantial identified highway needs.

The just-released 1987 Status of the Nation's Highways: Conditions and Performance, submitted to Congress by USDOT pursuant to Section 307 of Title 23, United States Code, highlights some of the problems of serious concern to highway users:

- o "...future travel demand is anticipated to increase an average 2.85 percent annually through the year 2000, reaching 2.7 trillion miles by the turn of the century;"
- o "...congestion has worsened since 1983, with the percent of peak hour travel on urban interstates under congested conditions increasing from 54 percent to almost 61 percent;"
- o "...bridge conditions generally deteriorated over the two-year period 1984-1986, when the proportion of Interstate bridges classified as being deficient rose from 10.6 percent in 1982 to 13.1 percent in 1984, and 14.3 percent in 1986."

The true irony of the current Federal tax hike proposals is that none of the revenues would build or fix a single highway or bridge, or ease congestion on vital urban arteries, at a time when needs are rapidly outpacing available funds, and when other Congressional budget constraints are already cutting back on revenues which should be made available to the states from the Highway Trust Fund.

The Joint Committee Report correctly points out that there are geographic inequities related to a gas tax hike -- consumers in some regions, who use more gasoline than the national average, would bear a disproportionate share of a major Federal motor fuel tax hike. For example, the per capita gasoline consumption in Illinois is 540 gallons per year; Texas 581 gallons; Indiana 706 gallons; while New York and Pennsylvania per capita consumption is 349 and 397 gallons respectively, and the District of Columbia is 302 gallons. (See Exhibit II.)

We do support repealing the six cents gasohol exemption from the Federal motor fuel excise tax. The current subsidy had some justification when it was assisting a fledgling alcohol industry get under way. That rationale no longer holds. The Department of Agriculture estimates, based on the 1986 production cost of corn-based ethanol at $1.60 per gallon, that increasing the annual fuel ethanol production from the current 600 plus million gallons to 2 billion gallons -- with present tax exemptions -- would cost Federal and state governments more than $6.1 billion by 1995, and eliminating the exemption would save more than $3.5 billion by 1995.

Finally, the Highway Users Federation strongly supports measures which would curb evasion of lawfully imposed motor fuel taxes. According to the Federal Highway Administration, an estimated $1 billion may not now be collected for deposit in the Highway Trust Fund at today's excise tax level, and of course higher tax rates would provide added incentive to evade. In the final analysis, highway users are the ultimate victims when motor fuel

taxes, intended to improve the nation's highway transportation facilities, are evaded.

We are at the threshhold of the post-Interstate era, but there is no national highway policy beyond Fiscal Year 1991 when current authorizations expire. It will be up to the Congress to craft a national highway program that will effectively serve America's needs into the 21st century. It is then that the question of increased motor fuel taxes specifically to pay for road needs should be debated, not now, and not for general revenue enhancement purposes.

The proposed hike of the Federal motor fuel tax for deficit reduction purposes sets a dangerous precedent which could adversely affect the future Federal-state highway partnership. The present strength and solidarity of that partnership has already been severely tested during the many months of delayed reauthorizations, delayed Interstate Cost Estimate approvals, and cutbacks in funding levels preceding enactment of the 1987 Surface Transportation and Uniform Relocation Assistance Act.

We believe these are compelling reasons why a motor fuel tax hike for deficit reduction is a bad idea, and we urge the Committee to dismiss it once and for all.

Thank you.

EXHIBIT I

STATE MOTOR FUEL TAX RATES

(cents per gallon)

STATE	GASOLINE	DIESEL	GASOHOL	MOTOR CARRIER TAX	LOCAL OPTION
ALABAMA	13	14	10		L
ALASKA	8	8	8		
ARIZONA	16	16	16		
ARKANSAS	13.5	12.5	13.5		
CALIFORNIA	9	9	9	6	L
COLORADO	18	20.5	18		
/CONNECTICUT	18	18	17	2	
DELAWARE	13	13	13		
D.C.	15.5	15.5	15.5		
/•FLORIDA	9.7	14.7	5.7		L
GEORGIA	7.5	7.5	7.5	3	
HAWAII	11	11	11	4	L
IDAHO	14.5	14.5	10.5		
ILLINOIS	13	15.5	13	6	L
INDIANA	14	15	14	5	
IOWA	16	18.5	15		
/•KANSAS	11	13	11		
•KENTUCKY	15	12	15		
LOUISIANA	16	16	16	1	
MAINE	14	14	11		
MARYLAND	18.5	18.5	18.5		
•MASSACHUSETTS	11	11	11		
•MICHIGAN	15	15	15	4	
/MINNESOTA	17	17	15		
/MISSISSIPPI	15	15	15		L
MISSOURI	11	11	11		
/MONTANA	20	20	20		
/•NEBRASKA	17.6	17.6	14.6		
/NEVADA	16	17	15		L
NEW HAMPSHIRE	14	14	14		
NEW JERSEY	8	11	8		
/NEW MEXICO	14	16	3		L
NEW YORK	8	10	8	6.75	L
•NORTH CAROLINA	15.75	15.75	15.75		
/NORTH DAKOTA	17	17	13		
/•OHIO	14.7	14.7	14.7		
OKLAHOMA	16	13	16		
OREGON	12	12	12		L
PENNSYLVANIA	12	12	12	6	
•RHODE ISLAND	15	15	15		
/SOUTH CAROLINA	15	15	9		
SOUTH DAKOTA	13	13	11		L
/TENNESSEE	17	16	13		L
TEXAS	15	15	11		
UTAH	19	19	19		
VERMONT	13	14	13		•
VIRGINIA	17.5	16	17.5		L
WASHINGTON	18	18	16.2		
•WEST VIRGINIA	15.35	15.35	15.35		
•WISCONSIN	18	18	18		
WYOMING	8	8	8		

• Variable tax expressed in cents per gallon.
See notes on reverse side for additional information.

/ Updated since last chart
Highway Users Federation
July 1, 1987

EXHIBIT I - continued

NOTES

Alabama - Includes 2 cent "inspection fee"
Arizona - Motor fuel tax increases 1 cent on 7/1/90
Connecticut - Another 1 cent/gal to be added each July 1 through 1991
Florida - Variable: 4 cents + 5% retail average (5.7 cent floor on sales tax portion)
Georgia - Plus 3% on retail price excluding state taxes
Hawaii - Diesel tax includes 1 cent/gal tax for highway use; gasohol is exempt from sales tax
Illinois - 4% sales tax on gasohol
Indiana - Plus 8 cents special fuels surcharge on commercial vehicles paid quarterly
Kansas - Variable: 10.5% of unwtd. average retail
Kentucky - Variable: 9% wholesale average + increase of 1 cent for each 2 cent decrease in wholesale price;surtax on trucks 2.2 cents/gal, paid via report
Louisiana - Motor fuel subject to 1% sales tax 7/1/86 - 6/30/88, (one year extension passed in 1986).
Massachusetts - Variable: 10% wholesale average
Michigan - Variable: Federal Operations & Maintenance Cost (FOMC) + consumption (2 cent max. per year)
Mississippi - Effective 7/1/87 removal of 6% sales tax on motor fuels as well as gasoline & Diesel tax increases: 7/1/87 6 cents/gal, 1/1/88 2 cents/gal, 1/1/89 1 cent/gal, thereafter, taxes revert to: Gasoline - 14.4 cents/gal,Diesel - 14.75 cents/gal
Nebraska - Variable: 12.5 cent base plus excise tax
Nevada - Gasoline tax increase 2 cents, diesel 3 cents 7/1/88.
New York - 4% sales tax; 2.75% gross earnings tax on oil co.
North Carolina - Includes 0.25 cent inspection fee. Variable: Effective 7/15/86 increase of 2 cents plus 3% of wholesale average
Ohio - variable: Effective 7/1/87 to be adjusted March 1 each year 1988 thru 1993. Ceiling on increase is .8 of one cent/gal. Calc. using maint. index factor & consumption of motor fuel.
Oklahoma - Includes 0.08 cent inspection fee
Oregon - Diesel taxed through ton-mile structure
Pennsylvania - 6% is wholesale franchise tax; varies between 5.4 cents and 7.5 cents
Rhode Island - Variable: 11% wholesale average + excise tax equal to 2% of wholesale price
South Carolina - Motor fuel tax increases 1 cent 1/1/89.
South Dakota - Dealers blndg ethanol w/ gas recv. 1 cent/gal credit
Tennessee - Incl. 1 cent special petroleum tax for gas and diesel
Texas - Temporary motor fuel tax increase of 5 cents enacted 1986 effective 1/1/87 - 8/31/87
West Virginia - Variable: 10.5 cents + 5% wholesale average
Wisconsin - Variable: Federal Operations & Maintenance Cost plus consumption

EXHIBIT II

ESTIMATED GASOLINE USE AND TAXES – 1987

Ranked by Per Capita Use by State

State	Total Use Mil.Gal	Per Capita Use Gal/Person	Tax Rate ¢/gal	Total Tax Mil. $	Per Capita Tax $
DE	3989	706	23.00	917.4	162
KY	2677	692	36.00	642.4	166
MD	474	673	22.00	104.3	148
MO	456	669	22.00	100.4	147
TN	3152	665	26.00	819.4	168
NE	1028	635	28.00	287.8	178
KS	1534	623	20.00	306.8	125
LA	1813	620	25.00	453.3	155
NM	2300	587	26.00	649.9	153
WA	3401	586	26.50	901.3	155
TX	9779	581	24.00	2346.9	140
OK	1942	574	25.00	485.4	144
AL	2353	574	22.00	517.6	126
MO	2859	566	20.00	571.7	113
GA	3429	566	16.50	565.8	93
LA	2368	560	25.00	642.0	140
NE	345	551	22.00	75.8	121
NM	816	549	20.00	163.1	110
OH	5882	548	21.00	1237.4	115
MT	462	543	26.00	120.0	141
IL	6228	540	22.00	1370.1	119
WV	973	535	22.00	126.1	118
NC	3241	527	24.75	826.9	130
MI	4729	513	25.00	1182.2	128
AR	1254	513	22.50	282.2	115
AK	245	508	17.00	45.0	86
NE	802	506	23.00	138.5	116
VT	294	502	17.00	50.0	85
CO	1720	500	27.00	464.4	135
MS	1305	488	18.00	234.9	88
VT	269	488	22.00	59.2	107
NJ	3648	484	17.00	620.2	82
AZ	1692	482	25.00	423.1	121
CA	12787	477	18.00	2303.4	86
CT	1500	475	26.00	389.9	123
ND	2100	474	27.50	577.5	130
RH	499	473	23.00	114.7	109
SC	1621	472	22.00	356.6	104
FL	5698	469	18.70	1065.5	88
ID	508	467	23.50	119.4	110
WA	2133	459	27.00	575.9	124
UT	796	441	28.00	222.9	124
MA	2544	441	20.00	508.8	88
WI	2149	440	27.00	580.1	119
RI	408	424	24.00	97.9	102
WY	204	422	15.35	128.1	65
OR	1225	417	21.00	257.3	88
PA	4482	397	21.00	983.3	83
NY	6301	349	17.00	1071.2	59
HI	378	347	20.00	75.6	69
DC	174	302	24.50	42.6	74
US	123733.22	507.00	22.35	27202.29	114.43

Notes:
Gasoline tax effective 6/1/87 incl. 9¢ Federal. Highway Users Federation.
Gasoline Consumption includes Gasohol. Based on 1986 figures FHWA MF33GA expanded.
Population based on Census estimates for 1985 and 1990 interpolated.
Tax is computed on full consumption without regard to gasohol or other exemptions.

Mr. RANGEL. Could we hear from Joseph Ackell.

STATEMENT OF JOSEPH J. ACKELL, SENIOR VICE PRESIDENT AND CHIEF LEGAL OFFICER, NORTHVILLE INDUSTRIES CORP., REPRESENTING INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

Mr. ACKELL. Mr. Chairman, members of the committee, my name is Joseph Ackell. I am a senior vice president of Northville Industries Corp. of New York and I am here today to testify on behalf of IFTOA, the Independent Fuel Terminal Operators Association, solely on the issue of the point of collection of Federal excise taxes on gasoline.

I have submitted a comprehensive statement and I would like today simply to focus on what appear to be the principal aspects and perhaps to be the principal issues connected with the proposed change of the point of collection of taxes to what is called the finery gate or the point at which gasoline actually leaves a refinery. Or, in the case of imported gasoline, the point of import, in other words, Customs entry of gasoline.

In the case of the refinery gate, the tax would become due at the point of departure and would be remitted by the refiner rather than the current method which is twice a month—it would be remitted on a weekly basis by electronic transfer.

And I will get to the significance of the weekly remittance when I address the issue of what is called float.

On the point of import, in the case of imported gasoline, U.S. Customs would collect the tax as simply another line item, another tax that would be collected in the manner in which duties and fees such as the newly instituted harbor maintenance fee is currently collected by the U.S. Customs Service.

Not only does it simplify the process of collecting gasoline taxes, but it increases the amount that is collected.

First of all, as my colleagues here, Mr. Archer and Mr. Lamm have stated, the issue of evasion is a very, very significant one.

Whether the amount of evasion going on today is $500 million or it is $800 million, as the FBI indicated at an oversight subcommittee hearing here, or it is a billion dollars as a member of the underworld testified behind a screen last year, it is a great deal of money.

The current proposal makes a revenue estimate of an increase of $300 million more simply by the acceleration of the collection that occurs by moving upstream to the point of collection, the refinery gate or the point of import.

Now, some say that there is a float problem, float being that added working capital that a jobber or a dealer has because on a current basis the tax is collected but remitted perhaps a week or 10 days later.

What happens when the point of collections move to the refinery gate and the point of import? What happens is it equalizes competition.

The refiner does not get the benefit of the float, because as I understand the proposal there is an acceleration of the time at which transfers occur.

Nobody out in the marketplace is getting the benefit of float. As a matter of fact, in my testifying here today on behalf of terminal operators, this proposal would take the float away from us that would be given under the current law, which would be implemented on January 1, 1988.

What is the impact on competition by this proposal? The impact on competition is that it equalizes everybody. But more importantly, by moving upstream the point of collection it virtually eliminates cheating.

Cheating is not competition. Cheating, honest marketers cannot compete with. Cheating turns honest people into less than honest people and sometimes puts them out of business if they choose to stay on us.

I come from New York and I was involved with tax evasion in New York, which developed as a problem on a massive, massive scale for a single state.

Our estimates were in 1982–83 that New York State alone was losing about $200 million a year from gasoline tax cheating. It took about 2 years to change a legislative amendment that was intended to correct cheating, but created a distributor network in New York that turned what had been evasion at a minor scale to one that turned into cheating and evasion of massive proportions.

An organized crime strike force was formed for the purpose of addressing that problem. And it consisted of the Federal elements, the FBI. It consisted of the state auditors, the State district attorneys.

It took 2 years for the organized crime strike force to start returning indictments, which they finally did. And it finally corrected the problem with further amendments moving upstream the point of collection, and New York collected in its first year $160 million more than it had in the prior year before the change, moving the point of collection as far upstream as a State can do. Thank you, Mr. Chairman.

Mr. RANGEL. Thank you, Mr. Ackell. Without objection, your statement will be placed in the record in its entirety.

[The statement of Mr. Ackell follows:]

Joseph J. Ackell
Independent Fuel Terminal Operators Association
1250 Connecticut Avenue, N.W.
Washington, D.C. 20036
(202) 637-9000

I am Joseph J. Ackell, a Senior Vice President and Chief Legal Officer of Northville Industries Corp. of Melville, New York. Northville is an independent marketer and trader of refined petroleum products principally in the Mid-Atlantic states; we operate several deepwater terminals in New York and New Jersey with approximately 11 million barrels of storage capacity.

I am appearing today on behalf of the Independent Fuel Terminal Operators Association ("IFTOA"). IFTOA strongly supports the proposal to move the collection point for federal gasoline excise taxes to the top of the petroleum distribution system. This revenue option appeared in the "Description of Possible Options to Increase Revenues prepared for the Committee on Ways and Means" by the staffs of the Joint Committee on Taxation and the Committee on Ways and Means.1/ It simply builds on the efforts of the Congress in the last session to eliminate gasoline tax evasion.

IFTOA is composed of 19 companies which operate 57 deepwater and 42 barge oil terminals along the East Coast from Maine to Florida.2/ None is affiliated with a major oil company. Members are primarily marketers of residual fuel oils (Nos. 4, 5 and 6 fuels) and home heating oil (No. 2 fuel); several companies also market significant volumes of gasoline at wholesale and retail levels. Members handle nearly 50% of the non-utility residual fuel oil shipped to the East Coast, nearly 60% of the non-utility residual fuel oil shipped to New England, 25% of the No. 2 heating oil shipped to the East Coast, and nearly 50% of the No. 2 heating oil shipped to New England.

I. Current Law

Current federal law provides for a tax of 9.1 cents per gallon on motor gasoline. Section 4081 of the Internal Revenue Code. The tax is designed to be imposed at the manufacturer's level; however, in many situations the tax may be deferred to the end of the distribution chain through tax-exempt transfers. Thus, the tax is generally collected and remitted to the Internal Revenue Service by either the distributor selling gasoline to the retail marketer or the retail marketer.

Unfortunately, this system of deferral has resulted in substantial tax evasion. Firms have engaged in complex transactions to obscure recognition of the taxable entity, including but not limited to "daisy chain" operations; in these transactions companies operating with invalid tax exempt certificates purchase gasoline and resell the product many times in paper transactions.3/

Last July, the Subcommittee on Oversight of this Committee held a hearing to determine the magnitude of the problem. Treasury officials estimated the loss of revenue to the Federal Government from such evasion to be about $200 million annually.

1/ U.S. Government Printing Office, "Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means" at 66 (June 25, 1987).

2/ A list of members and a description of the Association is attached. (Attachment A).

3/ Numerous bogus or "shell" corporations have been able to obtain tax exempt certificates. In other cases, otherwise legitimate firms hold forged or cancelled certificates. Because the Federal Government does not maintain a centralized list of tax exempt certificates, it is not possible for distributors who deal with such firms to verify the validity of a certificate presented to them.

A private consulting firm, National Economic Research Associates, Inc., published a report this January placing the loss at more than $500 million; the Federal Bureau of Investigation testified last summer and more recently stated its conclusion that gasoline tax evasion costs the government as much as $800 million per year.4/ Finally, a gasoline marketer, who had been involved in elaborate tax evasion schemes in New York, testified that the loss was closer to $1 billion annually. These amounts represent significant losses to the Federal Government.5/

II. Tax Reform Act

To address this problem, the Tax Reform Act of 1986 (P.L. 99-514) moved the point of collection of the tax, effective January 1, 1988, "up stream" to the refiner, importer or terminal operator. Specifically, the law provides:

1. if a refiner or an importer (a non-terminal operator) removes oil from a facility or sells it, without transferring the oil in bulk to a terminal operator, the refiner or importer will collect the tax;

2. a bulk transfer of gasoline from a refiner or importer to a terminal operator is not considered a removal or sale; and

3. if a terminal operator receives gasoline, it collects the tax on the earlier of (a) the removal or (b) the sale of the gasoline.6/

The Treasury Department plans to issue proposed regulations to implement this provision in the near future. It appears that those regulations will, in most instances, make removal from the terminal the taxable event and the terminal operator the collector of the tax.

III. Proposed Revenue Option

IFTOA believes that deferring tax collection to the point of removal from the terminal does not satisfactorily correct collection abuses because it continues to provide marketers with significant opportunities to avoid the payment of the tax, and it may even have the unintended result of actually increasing the evasion. For example, once gasoline enters a terminal, particularly oil not owned by the terminal operator, it can be bought and sold many times over.7/ Such turnover makes it

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4/ Pasztor, Andy and Gutfeld, Rose The Wall Street Journal, "Fuel Fraud," p. 1 (February 6, 1987).

5/ Tax evasion not only deprives Federal and state governments of taxes owed; it also places legitimate businessmen at a substantial competitive disadvantage. For example, in the State of New York federal and state gasoline taxes total about 30 cents per gallon. If a company is able to avoid paying that tax liability, it can undersell honest businessmen by a substantial amount and greatly diminish their market share. The consumer may benefit from this initial dishonesty through lower gasoline prices; however, the consumer will ultimately pay higher taxes in other contexts to compensate for the loss of gasoline tax revenues.

6/ The law does not address the issue of how to handle shipments between terminals or exchanges.

7/ In many instances importers of refined petroleum products do (footnote continued)

difficult to trace the ownership of the oil leaving the terminal and increases the likelihood that the tax will remain unpaid.

To implement Congressional intent and avoid tax evasion, IFTOA recommends that Congress adopt the collection amendment proposed in the Description of Options. The amendment should include the following elements:

1. Domestic Gasoline

Tax is imposed upon the removal of gasoline from the refinery; it is paid and collected by the refiner.

2. Imported Gasoline

Tax is imposed at the port of entry when it enters the United States; it is paid by the importer of record and collected by the U.S. Customs Service.

3. Remittance

To prevent any refiner or terminal operator from obtaining a competitive advantage by holding the collected taxes, remittance to the Federal Government would be required every week. However, the filing requirement of a quarterly tax return would not be changed.

IV. The Float

Gasoline distributors who purchase product from refiners or terminal operators have been advocating that they serve as collectors of the tax. Their objective is to hold the money for a limited time prior to remittance. During this time, these distributors would have use of the funds; they could either deposit the money in an interest-bearing account or use the funds to reduce working capital requirements. The "float", the term used to describe the holding of the collected tax revenues, is beneficial because it provides a marketer with extra working capital. Currently, these distributors oppose the move of the tax collection point to the refiner or terminal operator because they would like to retain the float which they believe to be significant.

In 1985, the National Economic Research Associates, Inc., a private economic consulting firm, analyzed and quantified the float earned by New York distributors on collection of state taxes.8/ NERA determined that the float was far less significant than originally thought and ranged from $100 to about $500 per month for each distributor. Thus, it was not an essential source of income for such distributors. An analysis of the value of the float based on the collection of federal taxes is likely to produce a similar conclusion.

Moreover, placing the point of collection further down the distribution chain to provide certain marketers with the "float" undermines the purpose of the law -- to eliminate or at

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(footnote continued from previous page)
not own their own terminal and storage facilities. Thus, they retain the services of a terminal operator to perform the function of unloading the vessel and placing the oil in storage for subsequent distribution. For these services they pay a terminalling fee. In these instances the importer, not the terminal operator, holds title to the product.

8/ Evasion of gasoline excise taxes has been a significant problem in New york during the prior five years.

least substantially reduce tax evasion. Any benefits from the float are far outweighted by the threat of greater fraud and tax evasion.9/

V. Increased Taxes

At present there is much discussion in Congress about increasing the federal gasoline excise tax. For example, a revenue proposal to increase the tax by 5 or 10 cents per gallon appears in the Revenue Options booklet.10/ Assuming such a proposal is enacted, there will be substantially greater monetary incentive for tax evasion.

VI. Conclusion

Accordingly, the Independent Fuel Terminal Operators Association urges that Section 4081 of the Internal Revenue Code be amended to permit the imposition and collection of the federal gasoline excise tax at the earliest point of distribution. Such a measure would minimize tax evasion and bring substantial additional revenue annually to the Federal Government even at current tax rates. This proposed method of collection would more efficiently implement the objectives of the section originally adopted by the Congress as part of the Tax Reform Act last fall.

Thank you very much.

9/ Prior to 1982, New York collected its state and local gasoline taxes from gasoline retailers. This method proved to be burdensome; the large number of retailers (about 10,000) and their rapid turnover made administration and enforcement difficult. In an attempt to deal with this problem, New York State passed legislation in 1982 to collect these taxes from distributors, rather than retailers (as is now being proposed by the distributors), because there are only about 400 distributors statewide; it was thought that collecting taxes at this level would be easier to administer and enforce.

Unfortunatley, the legislation had the unintended effect of increasing significantly the financial incentives for gasoline tax evasion. Because the volume of gasoline handled by the average distributor was much greater than that handled by the average retailer, the amount of taxes to be paid by individual distributors was correspondingly larger. To evade these taxes, a variety of schemes was invented to sell gasoline without reporting the taxes to the State. Beginning in the last quarter of 1982, there was an upsurge in bootleg and other unreported gasoline sales; these sales resulted in lost tax revenues for the State and its localities and injured legitimate distributors who competed against dealers selling illegally low-priced gasoline. To correct the problem, in late 1985 New York moved the point of collection to the first import or sale. This change proved successful; in the first year following its implementation, the State of New York collected more than $160 million of additional revenue.

10/ U.S. Government Printing Office, "Description of Possible Options to Increase Revenues prepared for the Committee on Ways and Means" at 63 (June 25, 1987).

ATTACHMENT A

MEMBERS

INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

Astroline Corporation
Saugus, Massachusetts

Atlantic Fuels Marketing Corp.
Montvale, New Jersey

Belcher Oil Company
Miami, Florida

Bray Terminals, Inc.
Albany, New York

Castle Coal & Oil Co., Inc.
Bronx, New York

Catamount Petroleum Corporation
Chelsea, Massachusetts

Colonial Oil Industries, Inc.
Savannah, Georgia

Global Petroleum Corp.
Waltham, Massachusetts

Gulf Oil-Cumberland Farms
Canton, Massachusetts

Meenan Oil Co., Inc.
Syosset, New York

Northeast Petroleum Division
of Cargill, Incorporated
Chelsea, Massachusetts

Northville Industries Corp.
Melville, New York

Quinoil Industries, Inc.
Quincy, Massachusetts

C.H. Sprague & Son Company
Boston, Massachusetts

Steuart Petroleum Company
Piney Point, Maryland

Swann Oil, Inc.
Philadelphia, Pennsylvania

Webber Tanks, Inc.
Bucksport, Maine

Whaleco
Brooklyn, New York

Wyatt, Inc.
New Haven, Connecticut

The 19 companies listed above own and control terminals capable of receiving ocean-going tankers. None is affiliated with a major integrated oil company. Members of the Association are independent marketers of home heating oil (No. 2 fuel), residual fuel oils (Nos. 4, 5 and 6 fuels), gasoline and other petroleum products.

They distribute more than 50% of the No. 2 fuel oil consumed in New England and nearly 25% of the No. 2 fuel oil consumed along the East Coast. They distribute nearly 60% of the residual fuel oil burned by non-utility consumers in New England and nearly 50% on the East Coast.

The 19 companies own and control 57 deepwater terminals and 42 barge terminals, with a total storage capacity of over 58 million barrels. Of the total, about 26 million barrels are for No. 2 fuel oil, about 24 million barrels are for residual fuel oil, and about 7.4 million barrels are for gasoline and other products.

Mr. RANGEL. Mr. Chisholm.

STATEMENT OF PHILLIP R. CHISHOLM, EXECUTIVE VICE PRESIDENT, PETROLEUM MARKETERS ASSOCIATION OF AMERICA

Mr. CHISHOLM. Thank you, Mr. Chairman. My name is Phil Chisholm and I am the executive vice president of the Petroleum Marketers Association of America. PMAA is the largest representative of the independent petroleum marketers in the country.

Through its 41 State and regional associations, PMAA represents some 11,000 independent marketers who sell approximately half the gasoline, 60 percent of the diesel fuel and three-quarters of the home heating consumed in this country.

We very much appreciate the opportunity to appear before the committee today and would like to express our sympathies and condolences for the tough job the committee has in front of it.

We recognize the purpose of this hearing is to discuss revenue options and not to discuss general philosophy on deficit reduction and I will try to limit my remarks to that.

We first start out on what our basic philosophy is in terms of revenue increases and state that we believe that the first source of new revenue should be the elimination of tax subsidies that are currently made available to certain people and certain industries.

We believe specifically that tax subsidies, all tax subsidies, have to be reexamined in the light of the new economics the country is facing. And the specific subsidy we would recommend be eliminated is the current one granted gasohol whereby they get a 6-cent-per-gallon excise tax exemption and a 60-cent-per-gallon tax credit for gasohol blending.

We think that subsidy has outlived its usefulness. We think it could potentially raise as much as $1.7 billion over the course of the next 3 years and we think the subsidy has been misused in that it not only has made gasohol competitive in the market it has even given gasohol a competitive advantage in the gasoline marketplace.

So, we would recommend that being one source of revenue for this committee.

The second source, we think, of revenue for the committee is collecting the taxes that are owed, but not now being paid. And we talked quite a bit about gasoline and diesel fuel tax evasion already this morning.

We think that a proposal which is included in the revenue options by the Joint Committee on Taxation, which would allow marketers to collect the diesel fuel excise tax from their dealers and combine that with allowing marketers to collect gasoline excise taxes could raise anywhere from $400 million to $1.5 billion over the course of the next 3 years.

We also think there is a significant amount of revenue being left on the table by the result of the lack of IRS enforcement of existing tax laws.

There has been one cooperative study done between the States and the Federal Government on diesel fuel excise tax evasion, which found that, in fact, the return to the IRS was $3000 per audit hour.

We do not have a revenue estimate on what stronger enforcement can mean, but we think that the investments there would be well worth the return. We think the performance has been so bad up to this point that the Federal Highway Administration has even indicated that they would support an interagency agreement between the Federal Highway Administration and the IRS, which would allow the highway trust fund to fund in part the enforcement of the collection of the excise taxes.

A third philosophy we have when looking at the general question of tax increases, revenue enhancement, is that any new taxes, after all the money that is owed is collected and after all subsidies have been eliminated, should be as broad based as possible and apply equally as possible to as many people as possible.

The revenue options list a number of energy options, most of which we oppose. Energy is not a luxury. It is not a "sin tax." It is an economic necessity. It drives our economy.

And we support the comments made earlier in opposition to oil import taxes and gasoline excise taxes specifically.

And if, in fact, energy taxes are needed to reduce the Federal deficit, we would urge very very strongly that they would come in the form of a Btu tax.

The final point of philosophy we would make in terms of tax increases would be that in examining tax increases you examine carefully other public policy options and other public policy impacts of those increases.

I would like to comment just briefly on Mr. Ackell's proposal to raise the gasoline excise tax collection proposal to the refinery gate.

I think clearly that proposal is one where the cure for the disease is worse than the disease itself. The public policy implications of raising the gasoline excise tax procedure to the refinery gate are tremendous.

Because what you are doing is eliminating every incentive for anyone to keep any gasoline in primary inventories in this country.

If you have to pay nine cents a gallon up front, what is the incentive to have any inventories of gasoline or any stocks of gasoline by refiners or anyone else.

Given that situation, you are in a very, very serious situation should there ever be a supply cut off or a petroleum short fall in this country.

Moreover, you are in a very serious situation if refiners, in trying to project supply and demand ratios, because they do not want to pay the tax up front, miss that a little bit. And you have the potential to have gasoline lines or gasoline shortages in this country, even though there is a glut of crude oil and refining capacity available.

We would very, very strongly recommend that the public policy options far outweigh the one time tax benefit of raising the gasoline excise tax to the refinery gate.

We, again, express our strongest sympathies and condolences to the committee for the tough job they have in front of them. We would just urge that any new tax increases or any new revenue proposals be as broad based as possible and if energy is called on to handle its fair share that it be in the form of a broad based Btu tax

and no regional discriminatory or regressive taxes such as import fees and gasoline excise taxes. Thank you, Mr. Chairman.

Mr. RANGEL. Without objection, your statement will be placed in the record in its entirety.

[The statement of Mr. Chisholm follows:]

Statement of the Petroleum Marketers Association of America

Good morning Mr. Chairman and members of the committee. My name is Phillip R. Chisholm and I am the Executive Vice President of the Petroleum Marketers Association of America. PMAA, through its 41 state and regional member associations (see Attachment I), is the largest representative of independent gasoline and home heating oil marketers in the country. Nearly 11,000 independent marketers are represented by PMAA in Washington.

I suspect I could rattle off the names of a few member companies in each of your congressional districts and you would recognize them as outstanding small businessmen in their local communities. Aside from their business interests, however, I suspect you would also recognize them as being active in civic, social and political activities within the community.

This local image of the independent marketer should not belie his or her importance to the petroleum distribution network in this country. The 11,000 small business independent marketers represented by PMAA sell more than half the gasoline, 60 percent of the diesel fuel, and three quarters of the home heating oil consumed in America today.

We are pleased to have the opportunity to appear before this committee today to present our views on various revenue options to meet the targeted revenue levels required by House Concurrent Resolution 93, the Concurrent Resolution on the budget for fiscal year 1988. Before examining specific revenue options, PMAA would first like to briefly offer an overview on its perspective of deficit reduction in general. It would also like to offer its concern about legislating tax policy based on revenue estimates. Then specific revenue options PMAA opposes will be discussed, after which revenue options which merit support will be detailed. In discussing revenue options, either from a positive or negative perspective, PMAA will focus exclusively on areas related to the petroleum industry and not address general tax issues. These general tax issues have been and will continue to be addressed by other witnesses before this committee.

Overview on Reducing Federal Budget Deficits

As small businessmen, independent marketers are very supportive of efforts to reduce the federal budget deficits. They recognize the negative consequences such deficits have on the general economy and thus on their businesses.

In determining how the massive federal deficits currently being faced should be reduced, independent marketers believe the first step is to reduce federal spending and to eliminate waste in our federal budget. This is very similar to the philosophy applied to the energy industry during the 1970's that a barrel of oil saved through conservation is a barrel of oil that could be used in the future. Likewise, a dollar in reduced spending in the federal budget is a dollar not raised through increased taxes. We believe additional reductions in federal spending are possible, but we understand that is not the subject of debate at this hearing.

After federal spending is reduced by the greatest extent possible and additional revenue is still needed, PMAA recommends that a concerted effort be made to enforce all existing tax laws to ensure that revenues the government is currently entitled to are, in fact, being collected. As will be evidenced later by our testimony on motor fuel excise tax collections, much more can be done in this area.

Once federal spending has been reduced, all taxes owed are being collected and additional revenue is still needed, PMAA believes such new taxes should apply as broadly as possible, affecting everyone equally. Such new taxes should not be regressive; they should not discriminate regionally; they should not give one competing industry a competitive advantage over another, nor should they give particular competitors in the same industry a competitive advantage over others.

This test is a heavy burden for any new tax to meet, but we believe it is one which is absolutely necessary in order to restore fairness, equity and confidence in the federal tax system.

Tax Policy Through Revenue Enhancement

One disturbing trend that concerns PMAA greatly is Congress' willingness to make major changes in tax policies without fully assessing other public policy consequences of its action. It seems that Congress is so preoccupied with raising new revenue that if a proposal raises a few dollars, it's damn the other policy consequences, full speed ahead with new revenue. This "price tag" tax policy philosophy not only has disastrous consequences for affected industries, but also has long-run negative consequences for the entire country.

PMAA can speak first hand to this issue. During the early part of 1986 there was much concern over gasoline excise tax evasion. While there was some difference of opinion over the true extent of the evasion, all parties - the Administration, the Congress, and the industry - agreed the problem must be addressed and were willing to cooperate on ways to stop evasion whereever it occurred. The Administration's and the Congress' interest in this issue were pretty clear. For the industry the desire to stop evasion was equally compelling. If a particular competitor had a nine cents per gallon price advantage over someone else by virtue of not paying the federal excise tax, then that particular individual could destroy the profitability of other competitors, thus driving them out of that market and in the case of independent marketers, out of business.

In fact, the industry was so concerned about the problem of excise tax evasion that it brought it to the attention of government officials long before a strong concern was being expressed by anyone else.

The process of the Administration, the Congress and the industry trying to find a solution which ended evasion but which did not create distortions within the industry had been underway for only a few months when suddenly a price tag of $1 billion over four years was attached to a proposed change in the excise tax collection process that was adopted by conferees on the massive Tax Reform Act of 1986 (P.L. 99-514).

The new collection procedure was not in either the House or Senate tax bill and had not been subject to any public hearings. It took away the right of wholesale distributors to remit the tax to the federal government, a right expressly given by the Congress in the late 1950's because Congress recognized the competitive problems presented by requiring the wholesale distributor to pay the tax directly to its supplier. This re-created the same enormous problems for independent marketers that Congress had tried to correct in 1958.

Apparently, these problems were not considered once a revenue price tag had been attached to the proposal.

The only consolation to marketers in the whole process was that the change did not take effect until January 1, 1988. This was small consolation to one marketer who noted: "It's nice to have a year's notice before someone takes a considerable slice out of your business."

Let me reiterate that PMAA is firmly committed to supporting efforts to eliminate excise tax evasion on not only gasoline but diesel fuel as well. We believe, however, that can be accomplished in a way that makes marketers part of the solution rather than the prime source of the problem. Later in this testimony is a specific proposal by PMAA which will allow marketers to be part of the total motor fuels collection process and which increases revenue to the federal government.

Revenue Options PMAA Opposes

Below are a series of revenue options that PMAA specifically opposes as a means of generating the additional revenue mandated by House Concurrent Resolution 93. Most of these relate to direct new taxes on energy. PMAA does not believe that the energy industry can bear the brunt of additional taxes in light of the devastating impact that falling oil prices had on the entire energy industry in 1986. Moreover, we do not believe that consumers who saw their energy conservation efforts finally pay off in 1986 with the fall in oil prices should now be penalized for those conservation efforts by the imposition of new taxes which more than make up the recent price declines.

Energy is not a luxury. New taxes on energy can not be described as "sin taxes". Energy is an economic necessity. It drives our economy; fuels our homes; and transports our people and our goods nationwide. New energy taxes are inappropriate ways to raise new revenue and the only manner which PMAA could consider supporting new energy taxes is as part of a broad based tax hitting all industries equally.

Now PMAA will address specific energy tax proposals.

Oil Import Taxes:

PMAA opposes oil import taxes for several reasons. First, oil import taxes are inefficient ways of raising new revenue. A study by Exxon estimates that an $8 per barrel tax would generate $60 billion in higher energy costs for consumers. Only approximately one quarter of that amount or, $15 billion, would find its way into the federal treasury.

Secondly, such a tax is regionally discriminatory. It would affect disproportionately the northeastern section of our country where millions of homes are heated by home heating oil. This is, of course, unfair not only to those millions of consumers, but also to the thousands of home heating oil dealers who have offered fast, high quality, dependable home heating service to consumers for decades.

The third reason for opposing oil import taxes is that they will create competitive imbalances in the petroleum industry. These imbalances result from the fact that some refiners have greater access to lower cost, untaxed domestic crude oil than other refiners which have a greater dependency on higher cost imports.

Our fourth concern relates to ways in which the last two concerns might be handled. Government's track record in dealing with competitive imbalances resulting from different crude oil prices has been to create an entitlement program whereby refiners with access to lower cost crude oil pay entitlements to refiners dependent on higher cost crude. The government proved conclusively in the 1970's its inability to effectively regulate the oil industry. An oil import fee would invite direct government involvement back into the industry. Such involvement would only lead to greater industry problems and higher consumer prices as our 1970's experience clearly demonstrated.

Moreover, some have suggested that home heating oil might be exempted from any oil import tax. Since heating oil is a refined product derived from a barrel of crude oil, there is virtually no way to exempt it without in fact regulating its price and the price of other petroleum products as well.

Fifth, oil import taxes have a strong negative impact on the general economy. They lead to lower GNP, higher inflation, and higher unemployment. They also place domestic manufacturers at a competitive disadvantage with foreign manufacturers. These negative economic impacts result in greater government outlays for social programs and unemployment benefits.

Sixth, oil import taxes, while perhaps benefitting some banks with high domestic energy loan portfolios, will seriously hurt other banks that have loans to foreign countries including Mexico and Venezuela from which we now import considerable amounts of oil. Suggestions that these countries be exempt from such a tax are naive and fail to recognize that such exemptions would be counterproductive to the overall goals of the tax and would increase the level of federal involvement in the administration of the tax.

Seventh, an oil import tax violates the General Agreement on Tariffs and Trade (GATT). Already, the U.S. has been found in violation of the GATT treaty for enacting a small tax differential between imported and domestic oil as part of last year's Superfund legislation. PMAA would recommend that differential be deleted and for the U.S. to maintain full compliance with its GATT obligations.

Eighth, PMAA believes that while import taxes may stimulate increased domestic oil production, it will not stimulate increased exploration. Exploration incentives are needed, but an import tax that can be offered and taken away at the whim of Congress is not an appropriate incentive.

In summary, PMAA opposes oil import taxes because we believe they are inefficient means of raising federal revenue; they are bad for the economy; and, they represent unsound energy and foreign policy. We recommend they not be adopted as a revenue option. We recommend further that should an import tax be adopted over these objections, it should be applied equally to crude oil and all petroleum products. Providing a higher tariff on petroleum products would be little more than an unneeded subsidy to the domestic refining industry which lessens competition in the entire marketing segment.

Motor Fuel Excise Tax Increases:

PMAA opposes increases in the federal excise tax on gasoline and diesel fuel for many of the same reasons it opposes oil import taxes. Motor fuel excise taxes are regressive, impacting severely on lower income persons less able to pay higher taxes. As a percentage of income by class in 1985 families with incomes of less than $5,000 paid 1.62 percent of their income for gasoline excise taxes as opposed to families making over $50,000 which pay only 0.22 percent of their income. This means families earning less than $5,000 pay 7 times as much of their income for gasoline excise taxes as do families making over $50,000.

Motor fuel excise taxes are regionally discriminatory. They impact most greatly on rural states with little or no mass transit and individuals who must drive greater distances to get back and forth to work.

Increases in motor fuel excise taxes also have ripple effects through the entire economy. Higher gasoline and diesel fuel excise taxes mean higher transportation costs which mean higher prices for all goods and services.

The use of higher excise taxes as a means of deficit reduction also violates the basic tenet of excise taxes as a user fee which is deposited in the Highway Trust Fund to upgrade our roads and highways. Using excise tax revenue for purposes other than Highway Trust Funds is a dangerous precedent which should be avoided.

Other grounds for opposition to excise tax increases are the negative impact such taxes may have on the petroleum industry. A recent Congressional Research Service (CRS) study, Gasoline Excise Tax: Economic Impacts of an Increase, (May 13, 1987) shows that given the relative price and demand elasticity for gasoline, a 10 cent per gallon tax increase would reduce annual final sales by the industry by $9 billion. This will, of course, reduce industry profits "extending the recent decline in profitability and probably leading to the closing of more refineries and motor fuel outlets." according to the CRS. For independent marketers, specifically, an increase of 10 cents per gallon would also seriously affect the marketer's cash flow and reduce the available credit lines from his banks and suppliers.

In summary, PMAA opposes excise tax increases as a means of increasing revenue because they are regressive, regionally discriminatory, and would negatively affect the general economy. They would also set a precedent for diverting such funds from the Highway Trust Fund. Given the competitive nature of the petroleum marketplace, marketers and refiners would likely have to absorb part of the increase, thus worsening an already beleaguered oil industry.

Other Energy Taxes:

PMAA also opposes other proposed energy taxes including the broad based tax on petroleum and the BTU tax. Many of the arguments already expressed are equally applicable to these two taxes as well. However, if forced to choose a single tax on energy to be the energy industry's contribution to reducing the federal deficit, it would be the broad based BTU tax. Such a tax would apply equally to all fuels based on BTU content. Its principal advantage is that it would not provide, through new taxes, an incentive for one source of energy over another. A tax on just petroleum, however, would give incentives to purchase other fossil fuels, thus giving these fuels a competitive advantage in the marketplace.

PMAA believes all fuels should compete on their relative economic merits and government policy should not attempt to influence consumer choice in this area.

Collection of Excise Tax at Refinery Gate:

PMAA strongly opposes the revenue option listed by the Joint Committee on Taxation (JCT) which would provide for collection of the gasoline excise tax at the refinery gate. This is a prime example of what was described earlier as "price tag" tax policy.

On the surface, the proposal looks attractive because it could raise $300 million in FY 1988 without any increase in taxes. However, other public policy considerations would weigh heavily against this idea. Consider the following:

- Since refiners would be paying the tax on gasoline at the point of manufacture, they would maintain gasoline inventories at bare bones levels and operate their refineries to meet only their immediate needs. This could lead to spot shortages of gasoline, even gasoline lines, although there is no actual shortage of crude oil or refining capacity;

- The change would encourage a shift in the manufacturing process for gasoline from refineries to terminals as suppliers send unfinished gasoline from the refinery to the terminal where it will be blended with feedstocks to finish the manufacturing process. This could give some companies a competitive advantage over others and may lead to massive excise tax evasion;

- The incentive to import gasoline will become greater as refiners, terminal operators and others seek to reduce primary inventories to avoid payment of the excise tax until the last possible point in the distribution channel;

- Thousands of independent gasoline wholesalers and retailers would have their cash flow slashed as their major suppliers try to recover their lost cash flow by reducing credit terms to these marketers. This in turn will decrease the incentive for these marketers to maintain any measurable level of secondary storage;

- Regional refiners who operate retail service stations in close proximity to their refineries will have a clear competitive advantage because they will be able to collect the tax from their customers before it is due. This competitive advantage will have ripple effects throughout all surrounding markets.

For all of these public policy reasons, PMAA opposes moving the gasoline excise tax collection to the refinery gate.

Other Oil Industry Proposals:

While PMAA represents petroleum product marketers, we are also vitally concerned about the future viability of the entire petroleum industry, particularly in light of the devastating impact that last year's price decline had on the industry. In reality, however, not just the industry was impacted. The entire country will feel the impacts if the erosion of the domestic petroleum industry is not soon halted and reversed. Therefore, PMAA cannot support any proposals designed to raise revenue which negatively impacts the production and exploration industry.

Included in the package provided by the JCT were several such proposals including the elimination of the oil and gas passive interest provisions in last year's tax bill, repeal of the existing depletion allowance, and repeal of the provision relating to intangible drilling costs.

We do, however, support the Administration's recommendation that the Windfall Profit Tax be repealed. This is viewed as being revenue neutral in the JCT pamphlet and would remove a tremendous paperwork burden from many oil producers.

Revenue Proposals PMAA Supports

Gasohol Tax Exemption:

PMAA strongly supports the repeal of both the ethanol tax credit and excise tax exemption provided under current law. We believe, however, the actual loss

to the federal government to be much higher than that included in the JCT pamphlet.

In 1985 more than 6.5 billion gallons of gasohol was consumed. The federal tax subsidy for this consumption was more than $400 million either through the excise tax exemption or the 60 cents per gallon production credit.

Perhaps more frightening than the actual revenue loss is the growth in the use of gasohol. What was 6.5 billion gallons in 1985 began as 850 million gallons in 1981. If the same rate of growth occurs in the next three years as occurred between 1981 and 1985, the loss to the federal government over those three years will approach $1.7 billion.

This rate of growth is not unreasonable given the impact gasohol has had on the gasoline marketplace. Today gasohol is generally the lowest price unleaded fuel and marketers who sell that fuel have a competitive advantage over competitors who do not. Therefore, to remain competitive, more and more marketers are being forced to gasohol. This will increase both the demand and thus the tax loss to the federal government. PMAA does not believe federal tax subsidies should be used to give one competing fuel a price advantage over another.

The original intent of the excise tax exemption was a noble one which PMAA supported - get a fledgling industry off the ground and help the agricultural industry. It has been 10 years. The industry, if it is ever to survive, must do so without further subsidy. Independent studies have also shown this to be a costly, inefficient way of assisting farmers. A Department of Agriculture study showed it would be cheaper to provide direct subsidies to farmers than to continue these exemptions.

If this tax subsidy is eliminated the federal government would just be following a trend started by state governments. In 1986, approximately 11 states eliminated their excise tax exemptions for ethanol. Currently only 19 states still offer any form of tax subsidy.

Collection of Motor Fuels Excise Taxes:

PMAA believes significant sources of revenue still exist for the collection of federal motor fuel excise taxes. We also believe those collections can be made with independent marketers being part of the solution rather than part of the problem.

Specifically, PMAA urges that the Tax Reform Act of 1986 (P.L. 99-514) be amended in two ways. First, independent marketers who purchase product at the terminal and who meet specified financial responsibility requirements should be allowed to remit the federal excise tax to the federal government. This would correct the competitive imbalances created by the 1986 Act by allowing marketers the same terms and conditions as their refiner and terminal operator supplier/competitors. It would also allow the Treasury to collect the revenue in the same time frame as under the new law, thus resulting in no revenue loss. By maintaining the prohibition on tax exempt sales embodied in the Tax Reform Act, a relatively simple audit and enforcement trail is created. A marketer pays taxes on every gallon purchased so it is a relatively simple procedure to match up marketer excise tax remittances with sales and remittance reports which will have to be filed by refiners and terminal operators under the new law.

The Internal Revenue Service argument that they can't successfully audit 4,000 - 5,000 independent marketers who might take advantage of this proposal must be considered in light of the fact that they already must audit these same marketers for their diesel excise tax collections and remittances.

In fact, not only must they keep track of these few thousand marketers, but also tens of thousands of other marketers as well who are authorized to remit diesel fuel taxes. PMAA believes the number of diesel tax remittors is too great and would be supportive of ways to reduce that number.

One of the revenue options in the JCT pamphlet and a proposal supported by the Federal Highway Administration (FHWA) is to make mandatory an optional procedure included in last year's tax act. Under the new law, if wholesalers

and retailers agreed, the wholesaler would be allowed to collect and remit the diesel fuel tax. PMAA supports the proposal making it mandatory that the marketer collect the tax from the retailer. This, in effect, reduces the number of taxpayers from approximately 100,000 to fewer than 10,000.

The JCT estimates a revenue gain of approximately $400 million over the next three years if this proposal were adopted. The Federal Highway Administration believes the revenue gain to be much higher. They estimate conservatively the income loss to be $270 million per year and believe realistically as high as $500 million per year. If the FHWA is correct, the revenue gain from this proposal would range from $800 million to $1.5 billion over the next three years.

PMAA therefore supports making independent marketers the prime focus of all motor fuels excise taxes and believes anywhere from $400 million to $1.5 billion in new revenues could flow to the Treasury in the next three years.

Stronger Internal Revenue Service Enforcement:

The truth is that no system of excise tax collection or any tax collection system for that matter will be effective without at least some visible means of enforcement. It has been, and remains, the contention of PMAA that much of the motor fuel excise tax evasion is a direct result of the lack of any measurable enforcement actions by IRS. Many of the marketers PMAA represents say they have never been audited for excise tax collections. Many others say it has been 10 or more years.

The blame for this lack of enforcement must, of course, lie in part with IRS. But there are plenty of other reasons why evasion was such a problem. Previously, the system of collections made audit and enforcement extremely difficult. This was not as a result of there being too many taxpayers, as some would lead you to believe, but rather, that there were too many tax exempt transactions throughout the distribution process. Because of such numerous transactions an IRS auditor may have to track a load of gasoline through several hands before determining whether the correct level of tax was actually paid.

The Tax Reform Act corrected part of this problem by redefining the point of taxation for gasoline as when the product breaks bulk at the terminal rack and disallowing tax exempt sales to end users downstream and by creating the option of allowing marketers to collect diesel fuel excise taxes from dealers. But, Congress overreacted on gasoline and did not go far enough on diesel fuel. As PMAA has earlier recommended, qualified independent wholesalers should continue to be allowed to remit gasoline excise taxes for their product purchases at the rack to the Treasury and the optional wholesaler collection procedure for diesel fuel should be made mandatory.

We reiterate, however, that no system is going to be effective without a commitment by Congress to provide the enforcement tools necessary and a commitment by the Internal Revenue Service to use those tools. Even the new system of gasoline excise tax collection set to take effect on January 1, 1988 is subject to widespread abuse if not monitored and audited properly. Through all of our conversations with Treasury and IRS officials, PMAA does not sense any stronger commitment to enforcement than there was before the levels of widespread evasion were publicized.

Certainly increased enforcement would cost money. But we believe it would pay for itself. PMAA was shocked to learn, for instance, that the excise tax collection monitoring system is still done manually. Can the government afford not to automate the collection of more than $10 billion in revenues each year?

One basis for concluding that stronger enforcement would pay for itself comes from the Cooperative Federal/State Exchange Project For Excise Taxes On Refined Petroleum Products issued last year. This project was done to determine the feasibility and effectiveness of materially increasing the cooperation between IRS and state personnel in assessing compliance and non-compliance with the payment of excise taxes on certain refined petroleum products.

The results of the diesel fuel phase of this project are astounding. Diesel fuel excise tax returns were audited for 25 remittors in seven different jurisdictions. The program recovered $1.8 million in tax and penalties owed the IRS on diesel fuel taxes alone. This is a return, according to the study, of almost $3,000 per audit hour.

Interestingly, the program also audited related federal tax returns and collected an additional $1.5 million for a return of $6,877 per audit hour.

Several conclusions can be drawn from this analysis.

First, stronger enforcement would, in fact, pay for itself. Secondly, such enforcement cannot come merely through changing the collection procedure, since the results show that those individuals not paying the diesel fuel excise tax are also cheating the government in the payment of other taxes.

Another interesting conclusion to be drawn from this analysis is the returns received by the states that participated in this cooperative effort. They collected only an additional $294,000 on diesel tax collections, 16 percent of the federal collections, and $152,000 on related returns, less than 10 percent of what the IRS found. Clearly, the states are doing a better job at excise tax collection and clearly those individuals who decide to cheat believe they can get away with it easier at a federal than at a state level.

PMAA would therefore make several recommendations:

(1) There should be a greater funding for IRS enforcement in the excise tax collection process. If this cannot be done through general revenues, then we urge acceptance of a recommendation made by the Chief Counsel of the Federal Highway Administration that would permit an interagency agreement between FHWA and the IRS under which disbursement could be made to the IRS from the Highway Trust Fund for administration of the collection of user fees for the trust fund. Either through general revenues or through the interagency agreement proposed by FHWA, the return would be well worth the cost.

(2) We urge vigorous oversight by the Congress for the excise tax collection procedure to insure that IRS is utilizing all available resources to reduce or eliminate excise tax evasion.

(3) We support the recommendations embodied in the Cooperative Federal/State Exchange Project Study: Diesel Fuel Phase on ways the states and the federal government can cooperate more fully in excise tax collection.

(4) We support the recommendation of FHWA Administrator Ray Barnhardt to create a trial program whereby some states would collect the federal excise tax at the same time they collect their own.

Implementation of these four steps should provide significantly new levels of revenue to the federal government.

SUMMARY

PMAA again appreciates the opportunity to testify today and we wish to urge again that in debating revenue options to meet the requirements of House Concurrent Resolution 93, that the committee keep five basic principles in mind. These include:

(1) The full public policy implications of specific revenue options must be debated and realized before adoption.

(2) The first source of new revenue be collection of taxes already owed but not paid. This would include modification of the gasoline and diesel fuel excise tax collection procedure, as recommended, as well as funding for stronger enforcement efforts by IRS.

(3) Any new revenue options be as broad based as possible in order to insure fairness and equity to everyone.

(4) Current government subsidy programs which are costly to the government and no longer serving a public purpose, such as the excise tax exemption for gasohol, should be eliminated.

(5) Regressive or regionally discriminatory taxes such as excise tax increases, oil import taxes, or broad based energy taxes be rejected.

I will be happy to answer any questions you may have.

PMAA PETROLEUM MARKETERS ASSOCIATION OF AMERICA

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ATTACHMENT #1

MEMBERS OF THE PETROLEUM MARKETERS ASSOCIATION OF AMERICA

The Petroleum Marketers Association of America represents the independent petroleum marketers who are members of these state and regional trade associations:

Alabama Oilmen's Association
Arizona Petroleum Marketers Association
Arkansas Oil Marketers Association, Inc.
California Independent Oil Marketers Association
Colorado Petroleum Marketers Association
Independent Connecticut Petroleum Association
Florida Petroleum Marketers Association
Georgia Oilmen's Association
Idaho Oil Marketers Association
Illinois Petroleum Marketers Association
Indiana Oil Marketers Association, Inc.
Petroleum Marketers of Iowa
Kansas Oil Marketers Association
Kentucky Petroleum Marketers Association
Louisiana Oil Marketers Association
Michigan Petroleum Association
Mid-Atlantic Petroleum Distributors Association, Inc.
Mississippi Petroleum Marketers Association
Missouri Oil Jobbers Association
Montana Chapter, Western Petroleum Marketers Association
Nebraska Petroleum Marketers, Inc.
Independent Oilmen's Association of New England
Fuel Merchants Association of New Jersey
New Mexico Petroleum Marketers Association
Empire State Petroleum Association
North Carolina Petroleum Marketers Association
Northwest Petroleum Association
Ohio Petroleum Marketers Association
Oklahoma Oil Marketers Association
Oregon Petroleum Marketers Association
Pennsylvania Petroleum Association, Inc.
South Carolina Oil Jobbers Association
South Dakota Petroleum Marketers Association
Tennessee Oil Marketers Association
Texas Oil Marketers Association
Virginia Petroleum Jobbers Association
Washington Petroleum Marketers Association
Western Petroleum Marketers Association
West Virginia Petroleum Marketers Association
Oil Jobbers of Wisconsin, Inc.
Wyoming Petroleum Marketers Association

The Petroleum Marketers Association of America is located at 1120 Vermont Avenue, N.W., Suite 1130, Washington, D.C. 20005. Telephone (202) 331-1198.

Mr. RANGEL. We thank the panel. Are any of you oil people familiar with the strategic reserve oil program that one of our committees is discussing where——

Mr. BUCKLEY. Yes, sir.

Mr. RANGEL. That is that the Government just takes 2 percent of the importer's oil and——

Mr. BUCKLEY. I am sorry, I did not hear the question.

Mr. RANGEL. Is that the plan where the U.S. Government takes about 2 percent of the oil imports and puts it in a hole in Texas and charges the importer for holding that oil for the country?

Mr. BUCKLEY. The way that proposal worked, Mr. Chairman, was that the importer had to take 2 percent of the value of his import in the form of crude oil and hold it in storage as a supplement to the existing Government program of putting oil in the ground in Texas and Louisiana.

It was kind of an industrial reserve to be paid for by the importer.

Mr. RANGEL. Well, your lawyers studied the constitutional impact on forcing oil importers to be involved in a national reserve effort?

Mr. BUCKLEY. I think the proposal was dropped in conference. But you are absolutely right. It would have a very negative impact on oil importers because the net effect of that proposal would be the imposition of the equivalent of an oil import fee.

Mr. RANGEL. What impact would that have on the price of oil?

Mr. BUCKLEY. Well, the proposal as made related to a fill rate of 75,000 barrels a day. If you assume only a 75,000 barrel a day fill rate, the committee's data showed that the impact would be in the 30 to 35 cents a barrel range. Just a little less than a penny a gallon.

But, in addition, there are tremendous administrative problems, because, of course, a lot of our imports are in the form of products and products are not crude oil.

And they had some kind of a system they were going to look at to make an equivalent saving on products so that basically it would, for all intents and purposes, be kind of a hidden oil import fee and would for the first take what has been a very successful public program, the Government financing of strategic storage, and put it in the hands of independent and major oil companies. And we just think that is very base public policy.

Mr. RANGEL. Would this have a greater impact, in your opinion, on the Northeastern States?

Mr. BUCKLEY. It would certainly have a negative impact, particularly on the east coast and the west coast where most of the importing takes place; to some extent on the gulf coast as well. But strictly the coastal communities rather than the inland communities.

Mr. RANGEL. Mr. DiBona?

Mr. DIBONA. Mr. Chairman, there was quite a bit of confusion about that. And this figure of 35 cents was generated by assuming that 2 percent over price that was in the $17 to $18 range would be about 35 cents.

But this is very difficult to determine. If it were simply oil delivered, put into the strategic petroleum reserve and then owned by

the U.S. Government, which was not the proposal as I understand it, that 35-cent increase would have been a correct estimate of the effect.

But as I recall the proposal, it was that the oil would be put into the reserve, the cost of storage would be borne by the importer and that—but at some point, when the President made a decision to pull that oil out, it would be—it would then be owned by the person who imported the oil and therefore paid for the oil to be put in there.

Now, that has some value to the importer, so it is indeterminate what the effect would be, I think. And it is highly unlikely that the effect would have been 35 cents. It might have been higher, it might have been lower, you simply do not know.

Mr. RANGEL. Who are you working with in the Congress on this issue?

Mr. DIBONA. Well, currently no one has been working actively with us at this particular point.

Mr. RANGEL. Well, whose idea is this——

Mr. DIBONA. This was an idea that was raised and then dropped and I understand it has been very recently raised again.

Mr. RANGEL. Who is raising it?

Mr. DIBONA. I personally do not know.

Mr. RANGEL. Would you know, Mr. Buckley?

Mr. BUCKLEY. I think the chairman of the Energy Committee, Mr. Dingell, Interstate and Foreign Commerce Committee, and Mr. Sharp were kind of the coauthors of this approach.

Mr. RANGEL. If you have any additional information on this, because I agree with both of you, it rises into prominence and then it falls and then it comes back and we do not know whether it is an oil import tax fee, whether it is a storage fee or who pays it. So you can help us because this information does not come out too openly on the floor.

Mr. DIBONA. I might add that we do not support this thing. We think that the storage of petroleum is something that is intended to protect the Nation, much as any defense expenditure would and that it should be raised by expenditures from general funds just as any insurance policy for this Nation is raised.

Mr. THOMAS. Will the chairman yield?

Mr. RANGEL. Yes.

Mr. THOMAS. I want to underscore the point that Mr. Buckley made. I know you coming from New York are focussing on the east coast question. It is a very serious question if this kind of law went into effect on the west coast as well.

We have already got a kind of an artificial movement of oil by congressional fiat from Alaska into California. And one of our big threats is Chinese gasoline, which currently is not commercial grade, but they upgrade it as they come.

And to simply say that the solution is to apply a fee to imported oil creates a rush into new and novel gasoline kinds of mixes and then you have got a bureaucracy that has to cover portions of oil, what is the ratio between low grade gasoline, high grade gasoline or other products that start coming in.

My understanding is the Budget Committee also was toying with this in terms of dollars and cents value of it, but it is the Fossil

Fuel Subcommittee, Mr. Sharp, of Indiana, and Chairman Dingell of the Energy and Commerce Committee that have continued to revisit this approach.

So, it is not just a question of oil. It is a question of a number of different products that we would be facing by virtue of what happens when you shut one door and another one opens.

Mr. RANGEL. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. I would also like to thank the Committee. When we refer to oil; sometimes, we associate it more with motor vehicles instead of the industry, petrochemical industry.

What percentage of a barrel of oil is actually used for motor vehicles?

Mr. DIBONA. About 45 percent of the oil refined in this country is refined into gasoline.

Mr. DUNCAN. You also mention the fact that tax on motor fuel would be disproportionate, unfair to certain sections of the country. Is that because—you mentioned the South and West, because in some States we do not have the subways and mass transit. Is that the reason?

Mr. DIBONA. Yes sir, if you take, for example, extremes like Wyoming, where when you want to visit your neighbor, you might have to travel 30 miles, the average consumption of gasoline is much higher than in other States.

But even within the State of New York, for example, the difference between consumption of residents upstate as opposed to people in New York City is very substantial.

So, it has markedly different effect. It is very disproportionate and in many instances some of the lower income people are the people forced to use more fuel.

Mr. DUNCAN. Do you have available the per capita use of motor fuel for each State?

Mr. LAMM. Excuse me, Mr. Duncan, it is attached to my written testimony. If you look at that, you will see that Tennessee is, indeed, the fourth highest per capita user of gasoline of all the States.

Mr. DUNCAN. Thank you. The petrochemical industries, particularly the plastics people, have indicated that they could not compete in foreign sales with a new tax. Would anyone care to elaborate on that?

Mr. BUCKLEY. I think what they are worried about—as you know, those are big export industries and big export earners for the United States and they basically use petroleum as a feed stock to generate all the end products that they make.

If you put some kind of a fee on domestic oil or on imported oil that puts it at a price level higher than the world level, then their ability to compete in the world market with finished products based on both their fuel cost and their raw material costs being higher here than anywhere else in the world—diminishes very sharply and, in fact, what you have is an import penetration by foreign chemical firms into this market, because they have a price advantage.

You really skew the foreign trade picture when you look at any energy intensive industry that uses a lot of petroleum or hydrocarbon both in fuel and in feed stock.

Mr. DUNCAN. Would any other member of the panel care to elaborate?

[No response.]

Mr. DUNCAN. If not, Mr. Chairman, I would yield back the rest of my time and I thank you and thank the panel.

Mr. RANGEL. Mr. Coyne?

Mr. COYNE. No questions.

Mr. RANGEL. Mr. Schulze?

Mr. SCHULZE. Thank you, Mr. Chairman. I, too, would like to thank the panel for some very interesting testimony. When I look at the figures, the Federal Government receipts on highway taxes, which, of course, include petroleum taxes, we have gone from $6.3 billion in 1981 to $13.7 in 1987, with a projection of $15.1 billion in 1988.

So, those taxes have increased fairly dramatically, almost tripled in that 8-year period.

I, too, am concerned about what a tax on imported petroleum does to the rest of the economy, the ripple effect. I would guess that 25 or 30 years ago, the bulk of our imported petroleum was in the form of crude oil.

Has that changed dramatically now as hydrocarbons and petrochemicals—has that mix changed dramatically over the last 25 to 30 years?

Mr. BUCKLEY. Not dramatically. There are more product imports now than there were then, both absolutely and as a percentage. But you are still looking at roughly 80 percent plus crude oil imports?

Mr. SCHULZE. Eighty percent.

Mr. DIBONA. Well, actually, I think it is a little lower percentage than that, because there are more products if you count No. 6 oil.

Mr. SCHULZE. That would surprise me if it had been steady, because I would think that other nations are looking at higher value added all the time and increasing that.

So, in your collective opinions, any type of tax on fuel other than ethanol would be the wrong direction to go right now.

Mr. BUCKLEY. Yes sir, yes.

Mr. SCHULZE. Let me ask you one question. Give me your thoughts on some form of broad based consumption tax in the long run for the overall good of our economy. Is that the way to go or should we continue with excise taxes and income taxes and capital gains and business tax, inheritance tax, all this mixture, should we start looking at broad based taxes?

Mr. DIBONA. That is the recommendation in our testimony. I should correct that—we are not recommending that there be a tax increase, but if there is an increase in taxes, the best way of doing it or the least worst way of doing it would be to do it in a way which dealt with the problem that this country is having.

It has one of the lowest savings rates in the world. It has been under investing in plants and equipment and the way to deal with that is if you are going to increase taxes—is to insure that you do not do it in a way which further exacerbates those problems.

The method of doing that is to tax consumption and not savings and investment, to make it as broad based as possible so that you do not skew investment in the country.

And, therefore, a very broad based consumption tax is the least worst or best of all of the alternatives that you are considering.

Mr. BUCKLEY. I would certainly agree with that. Moreover, I want to stress again that what you are interested in is deficit reduction, net revenue gain and that Data Resource study that I have attached to my testimony shows that a broad based Btu tax—not only can it be much, much smaller, because it is broad based, but you keep 87 cents on the dollar instead of 47 cents as in the case of a motor fuels tax or 7 cents in the case of an oil import fee.

Mr. SCHULZE. Mr. Buckley, would you be more definitive on that 7 cents on an oil import fee. I was kind of startled by that figure.

Mr. BUCKLEY. Well, what happens, basically, is when you look at a—not just the revenue collected, but what impact that has on the economy in terms of inflation, in terms of unemployment, in terms of additional Federal expenditures because of social programs there when you do have higher unemployment.

And because of the loss in production—you remember what happened in 1973 and the next 3 years, we had a real negative economy.

Again, in 1980, when the price of oil went up sharply, we had a very negative impact in the economy. That is what you are talking about here.

A $5 import fee is nothing more or less than a $5 hike in oil prices. And you have the same kind of negative impact.

And when you look at those impacts and feed them back through the gross national product computer that DRI used, they end up saying that the net effect, in terms of gain in revenue, was 7 cents on the dollar.

Mr. DIBONA. I might add there is one correction you have to make in any analysis of the effects of price rises in petroleum, whether they come as a consequence of an oil import fee or other wise.

There still exists something called a windfall profits tax. Once you are at the trigger level of the tax, then any increase in price for much of the oil in the United States redounds immediately to the U.S. Treasury.

And, therefore, the effects that appear to be the case without that tax are very different than with that tax.

Mr. SCHULZE. One final question for Mr. Archer. On the evasion of fuel taxes, in your opinion, if we were collecting all of the taxes which are due, what would be the difference? How much more in taxes would we collect.

Mr. ARCHER. Well, everyone has his own estimate, and the problem is that people who evade taxes are not going to disclose.

But we have used the $500 million estimate cited by FHWA. There are other figures. There are even estimates higher than that.

I think it is abundantly clear, however, that hundreds of millions of dollars in taxes are not being collected. The only question is how much.

It is very difficult to come up with a good estimate, but it is considerable.

Mr. CHISHOLM. Mr. Schulze, I think it is necessary to differentiate here between gasoline and diesel fuel. And last year the Congress took a step to improve—or to stop gasoline evasion by raising the collection process up.

At that point, the Treasury and the IRS—and based on available numbers we have never seen anything that would change that. It was estimating loss was somewhere in the range of $100 to $200 million per year.

We think the changes that are being made and the changes that we propose will collect the vast majority of that. On diesel fuel, there is a proposal being made, as part of the Joint Committee on Taxation recommendations, which we support, which would require distributors to collect diesel fuel excise taxes from their dealers, that could raise, according to the Federal Highway Administration estimates, $500 million a year.

According to the Joint Committee's estimates, it is probably going to be about $100 to $200 million a year.

Mr. SCHULZE. Thank you. Mr. DiBona, would you like to——

Mr. DIBONA. Yes, I would like to correct the record on what has happened with regard to the tax evasion and that is that changes were made by the Congress, this committee last year, that moved the point of collection of the tax back to distribution from the terminal.

At that point, there were reductions from many thousands of taxpayers and loads of opportunity for that kind of evasion to a few hundred taxpayers. Both this committee, the Joint Committee staff and the IRS have looked at that in some detail.

I think the numbers that were cited here about tax evasion related to the period prior to these changes being made.

If you now move it back to the refinery, what you do undoubtedly will bring about a reduction in inventories, because people will have to carry the full tax and, therefore, put more exposure on people in the Northeast and other places at the end of the line.

Furthermore, it will be harmful to citizens that are located distant from refineries because people will have to try and recapture that cost and the price will rise to those people.

Maybe the independent fuel terminal operators may benefit from that because they are—they then will be closer to the point of distribution. The tax will be paid closer to the point of distribution than it will be for other sellers of petroleum.

Mr. SCHULZE. So, you would disagree that——

Mr. DIBONA. That is right. I would stick right with keeping the point of collection at the terminal. There are relatively few taxpayers and, therefore, there is little opportunity for any kind of evasion.

The chain of receipts there has been very carefully looked at by IRS and your staff. It equalizes the payment of the—the amount of time lapsed from the payment of the tax.

Therefore, it does not benefit anyone indiscriminately and holds the cost down to all consumers throughout the country.

Mr. SCHULZE. Thank you.

Mr. ARCHER. Congressman, if I could comment briefly on that last point, I believe that diesel fuel is still collected right at the retail level. What Mr. DiBona said is absolutely correct with re-

spect to gasoline, but not diesel fuel and that is why we focussed on that. Thank you.

Mr. RANGEL. Mr. Andrews.

Mr. ANDREWS. I appreciate all of your testimony this morning. Mr. Buckley, in looking over your testimony, I noticed that one of the primary things that you said was that an import fee would shift income from consumers to producers. What do you mean by "producers"?

Mr. BUCKLEY. I mean, companies in the United States that produce oil.

Mr. ANDREWS. I am from one of those producing states. A lot of those producers are in my State. And I notice that you also state that the revenue gained is not efficient at all by your statistics. It is something like 7 cents on every dollar that we raise. Is that right?

Mr. BUCKLEY. That is correct. That was citing a recent study by the Energy Information Administration of the Department of Energy.

Mr. ANDREWS. What does that mean? Explain that a little bit for me, please, sir.

Mr. BUCKLEY. Basically, what happens is when you have an oil import fee, the price of domestic oil goes up by the same amount. And that is why there is a transfer to producers, because, of course, imports are only a portion of our energy requirements.

If you look at total U.S. energy requirements, imports make up 16 percent of that number. But by raising the price of those imports, since that is your marginal source of energy, gas and oil prices, generally, throughout the system also go up.

That is why it is inflationary and, of course, most of that revenue as your own data analysis shows, that was prepared by your staff—two-thirds of that revenue is transferred to producers.

But when that price impact rolls through the economy creating almost 500,000—loss of jobs, the unemployment of 484,000——

Mr. ANDREWS. Where will that loss of jobs comes from?

Mr. BUCKLEY. From all the industries that are negatively impacted by higher oil prices as they roll through the economy. All the industries I talked about: chemicals, steel, plastics, agriculture, as well as the loss of tourist industry from higher automotive costs.

The cost of interest rates in general goes up when you have an inflationary spiral. All of the same negative impacts that we had at the last price increase in 1980.

I understand, and I am very sympathetic to the plight of the producers in your State. They are in a very, very difficult position. They have gone through an enormously difficult year and a half and I would certainly urge, as Mr. DiBona did, that that windfall profits tax, which is still there, ought to be removed in order to give them a little incentive so if we do get a gradual increase price, it is not going to all flow to the Treasury.

Mr. ANDREWS. Do you believe the producing States will lose jobs as a result of an oil import——

Mr. BUCKLEY. The producing sector of the country has already lost jobs. They are down to kind of like a rock bottom——

Mr. ANDREWS. I understand that, Mr. Buckley, all too well. Do you think the producing States will gain jobs as the result of an oil import fee?

Mr. BUCKLEY. Yes, they will, but the Energy Information Administration studies shows a net loss of jobs to the general economy of 484,000.

Mr. ANDREWS. I am really trying to appreciate what you are saying. Are you not really saying that what happens in your view with an oil import fee is that profits shift from one region of the country to another, that producing States will gain at the expense of States like yours? Is that not basically what your testimony is?

Mr. BUCKLEY. No question. That is absolutely true.

Mr. ANDREWS. So, when you talk about a great loss of jobs and governmental expense, unemployment expense, that kind of Government expenditures that you think would be necessary, you are really talking about your region of the country, not my region of the country?

Mr. BUCKLEY. It is really a national number that I am using. The loss of jobs will occur throughout the economy. It is true that net—there will be a few producing states that will be in better positions, but at the cost of the rest of the economy. And I think that is a very dear price to pay.

And I again repeat that the function of this committee, particularly today, is to try to raise revenue to solve that $18 billion number that you need to fill in the Gramm-Rudman gap.

And if you are going to close that gap, you ought to look at efficient taxes that result in maximum revenue and a broad based tax is what does that.

Mr. ANDREWS. Mr. Buckley, my point is that when you say that profits just shift to producers, those producers also hire people to run their plants, and thus encourages economic growth in the producing States.

I mean, it is a regional problem that I think you are trying to focus on in your testimony, is it not?

Mr. BUCKLEY. Well, I certainly agree that the region you represent would benefit from an oil import fee. There is no question of that.

All I am saying is that the cost to the rest of the economy for the rest of the country would be very—it would be a very dear way to solve that problem when there are other ways to approach such as getting independent producers a better depletion allowance arrangement, such as eliminating the windfall profits tax.

Those are ways that I think, with very, very modest cost to the economy, will give additional incentives to producers and help a bit in getting them back on their feet.

Mr. ANDREWS. I think those suggestions do have merit. I wonder if you would comment—you did not in your testimony—about a gasoline sales tax. What would be your view on the importance of that kind of revenue measure?

Mr. BUCKLEY. Well, I think the Energy Information Administration study shows that a gasoline tax is far more efficient than an import tax in that you get about a 47 percent—47 cents on the dollar return to the Treasury.

But that comes nowhere near a general Btu tax, which is more like 87 percent. It kind of pinpoints the pain to selective numbers of people and it is a very regressive tax.

Mr. DORGAN. Will the gentleman yield?

Mr. ANDREWS. I would be happy to yield.

Mr. DORGAN. Precisely who did the study that you are referencing?

Mr. BUCKLEY. Yes, there are two recent studies. The first was done by the Energy Information Administration of the Department of Energy.

Mr. DORGAN. So, this is a study that was done by an agency that is opposed to an oil import fee in order to try and analyze why they are opposed to an oil import fee?

Mr. BUCKLEY. They were asked by the Congress to look at forming an energy policy for 1987. As part of that, they did a background data study to see what the effects of various policy options would be.

Mr. DORGAN. But the Department of Energy is opposed to an oil import fee as a matter of policy, is it not?

Mr. BUCKLEY. Well, when they saw the results of this study, that is the position they took. Yes.

Mr. DORGAN. The Department of Energy has been opposed to an oil import fee all along, have they not?

Mr. BUCKLEY. No, I think the——

Mr. DORGAN. As a matter of policy, the administration has been.

Mr. BUCKLEY. Yes, the administration certainly has been.

Mr. DORGAN. The Department of Energy is part of the administration?

Mr. BUCKLEY. Yes, it is.

Mr. ANDREWS. Just one more question.

Mr. RANGEL. The gentleman's time has expired, but if it is a brief question, you may proceed.

Mr. ANDREWS. Well, just to conclude, I really think what all of us on the committee are trying to do, in looking at a possible energy component to raise revenue—is regional balance.

And I appreciate your testimony. I do not agree with all the things you stated this morning, but I respect your concern for your region of the country.

And I think those of us from the Western and Southwestern States where distances are greater have great concerns about some of the suggestions you have made about a gasoline sales tax.

The burden that would be placed on those regions of the country could be well viewed inordinate in terms of the regional costs that would be placed in trying to raise enough revenues to reduce the deficit and meet our targets. Thank you, Mr. Chairman.

Mr. MCGRATH. Thank you, Mr. Chairman. And I want to thank the panel. Mr. Lamm, it seems to me I remember your face from 1982 when you were working for Secretary Lewis, coming around proposing a 5-cent-a-gallon tax on gasoline for use in the Highway Trust Fund.

Could you give me the amount of money that has been raised by that 5 cents in the past 5 years?

Mr. LAMM. Yes, sir, Mr. McGrath. I am the same party. I was Deputy Federal Highway Administrator at the time and worked

closely with the committee during the passage of the 1982 Surface Transportation Act, including the 5-cent-per-gallon motor fuel excise tax increase.

That excise tax increase immediately turned the situation around regarding revenue coming into the Highway Trust Fund, as it was designed to do.

Prior to the 1982 act's passage, the revenue level had held stable at $8 billion per year. Immediately after the passage of the act, the revenue went up, so that within a 12-month period the annual revenue level was running at about $12 to $13 billion. The revenue level now is up still in that same around, around $13 billion.

Mr. McGRATH. Who was paying that tax to the largest degree? The automobile driver? The truckers?

Mr. LAMM. Well, the nice thing about that tax is that nobody pays it unless he or she is actually out on the highway system making use of the facility because all of the revenue from the taxes goes to improving highways and bridges around the country.

As far as breaking down 175 million highway users by categories there is no doubt that an individual trucker per capita pays much more, because in addition to 15-cents-per-gallon diesel fuel tax, if he is driving a class 6 or higher truck, then he also has to pay the Federal use tax. And if he buys a new truck he pays Federal excise taxes on the truck and the heavy tires.

So, there is no doubt that the per capita input to the Highway Trust Fund is great from a trucker is very substantial.

Mr. McGRATH. Therefore, any increase in this tax on any level, whether it be an import fee or gasoline tax or anything else, would fall more heavily on the truckers than it would on any other entity that may use our roads.

Mr. LAMM. That is very true. In fact, Mr. McGrath, if a motor fuel excise tax applied to everything—gasoline and all special fuels including diesel, I believe the impact would be felt most heavily by the trucking industry.

Mr. McGRATH. And then, therefore, the consumer whose goods are being trucked by those truckers would be more severely impacted by some sort of passthrough clauses that truckers may have in their contracts with the distributors or manufacturers or whomever they truck for. Am I correct?

Mr. LAMM. Yes, sir. In fact with the current situation regarding economic regulation, unless there were very fierce competition in some part of the country, I believe most of that increase would be passed on to final consumers.

Mr. McGRATH. Thank you; Mr. Ackell. I was intrigued and, frankly, I know somewhat about the problem in bootlegging of gasoline in New York, it has been all over the papers. And I am somewhat intrigued by the proposal that you have brought forth even though Mr. Chisholm has some reservations regarding it.

Mr. Downey and I are working on some proposals that would provide for taxation as far upstream as we can determine it can be in order to make sure that it is collected.

It is a very big problem in New York, between the transporting of bootlegged gasoline and oil, between States in the region, and, frankly, I do not see any other way of making sure that we get our fair share at this particular level of government except by taxing it

as far upstream as we can, perhaps at the import level or perhaps at the refinery level or something like that. I would like you to comment on the proposal that Mr. Downey and I are presently working on.

Mr. ACKELL. Those of us who have lived the New York experience lived through a period of transition where the legislature in the State of New York concerned about evasion made the taxable event collection point midstream.

Midstream in that case was a class of distributors that New York would call 12(a) distributors and there was the belief that because there were only several hundred of those distributors, and that they would be bonded and investigated, that it would correct the problem.

The truth is it worsened the problem. Now, the new legislation and regulations that are to come into effect January 1, 1988, for Federal excise taxes on gasoline are, like in the New York case, a midstream event, in this case, its terminals rather than distributors.

We are such a terminal. I am sure that the system that members of IFTOA and Northville Industries have are capable of accommodating that.

But no model is perfect. And that is certainly what New York told us. You can believe that a fewer number of taxpayers and bonding and everything corrects the problem.

The experience tells you that it does not. And, therefore, in New York, it is collected at the point of import into the state or first sale into the State. And it is very, very stringently enforced.

Mr. MCGRATH. I see my time has run out, Mr. Chairman. I have no further questions. Thank you.

Mr. RANGEL. The Chair recognizes Mr. Downey.

Mr. DOWNEY. Mr. Chisholm, on the question of collection of gasoline excise taxes, if I understand your argument, it is that if we do it at the refinery gate or where it is imposed when it comes into this country, that it serves as a disincentive for people to stockpile gasoline. Was that the thrust of your argument?

Mr. CHISHOLM. That is one of the thrusts, yes, sir.

Mr. DOWNEY. What are some of the others?

Mr. CHISHOLM. I think some of the others from our standpoint is what it does to our members downstream, because immediately those costs are going to be passed on through the system and the ultimate person that is going to pay the higher cost for all of that will be the consumer of gasoline.

Mr. DOWNEY. Mr. Ackell, I think, made some fairly telling points to us that there is a price to pay, is there not, for not picking it up at the refining gate by virtue of the fact that we: (*a*) discriminate if we choose arbitrarily who downstream gets it; and, (*b*) that there is, whether we like it or not, an enormous incentive through the creative minds of some to not pay the tax.

Mr. CHISHOLM. I think you can argue that the ideal situation would be to have a single taxpayer. And there is certainly a lot of merit to saying we will have one person paying all the taxes. But in practicality that does not work.

And my contention is that in practicality the proposal by Mr. Ackell will not work effectively and that if you think it is going to

be any easier to audit a few refiners I suggest you talk to the Department of Energy who is just now completing the audits of the major oil companies for the overcharges for price and allocations during the control periods.

It is not going to be an easy process auditing at any level. And we think the terminal level is an appropriate place to tax. It was included in last year's tax bill. It has not even been tried to see if will work yet.

Mr. DOWNEY. On the competitive disadvantage to not stockpile gasoline, even if I were to incur an additional cost in the process of stockpiling gasoline, would I not be taking a risk, paying more money and potentially being in a better situation in the event there was a gasoline shortage even by incurring the additional cost of stockpiling gasoline?

I mean, is there not a competitive advantage to me by having incurred this cost, to have the stockpile, so that when there is a shortage I am in a position of having more gasoline than other people?

Mr. CHISHOLM. If you knew there was going to be a shortage, you certainly would.

Mr. DOWNEY. Well, but even if I did not know there was going to be a shortage or I had a sense that there was going to be a shortage—I mean, this is a business of risk, is it not?

Mr. CHISHOLM. It is certainly a business of risk and the only response I can give is right now there are many, many disincentives to primary storage in the first instance.

This adds one more disincentive to primary storage.

Mr. DOWNEY. Mr. DiBona, I see you want to get in. I want to ask, before you do, Mr. Ackell, to respond to this argument that Mr. Chisholm made about competitive disadvantage and also if he would respond to the argument that the auditing process is more difficult at the refining level than at other places.

Mr. ACKELL. Well, first on the question of stockpiles, gasoline stockpiles at the terminal level, which services the level that Mr. Chisholm is addressing, is kept for economic reasons at very low levels and there is a very, very high turnover.

As a result of increased costs of products and as a result of price volatility, those who own the product do not want to take those kinds of risks.

The proposal that is before us is one that imposes a tax at the departure point from a refinery. There is no payment of tax upon the manufacturer of gasoline. The payment of tax is when it is sold and it leaves the refinery.

So, it has no effect in my judgment on any other incentives there may be to maintain primary stocks at refineries. There is no added cost at that stage.

Mr. DOWNEY. I mean, what we are talking about here, with all due respect to Mr. Chisholm, is the fact that some of the people would like to collect the tax until it is remitted, collect the interest on the money, deposit it in the bank, is that not right? I mean, that is what we are talking about here. We are not talking about anything else other than that.

Mr. ACKELL. I think that is what it finally boils down to.

Mr. DOWNEY. And we are also not in the ethereal area of theory here alone. The fact is, the State of New York had been faced with this problem in the past and has found, has it not, Mr. Ackell, a method of dealing with it that has raised substantial amount of revenue from the very people who were avoiding the payment of taxes in the past?

Mr. ACKELL. It certainly has, Mr. Downey, and it is my understanding that Mr. Chu, the Commissioner of Taxation and Finance in the State of New York has recently sent a letter to this committee describing what has happened in New York.

Indeed, since his testimony here last year, before your subcommittee——

Mr. DOWNEY. Mr. Chairman, without objection, I would like to put Mr. Chu's letter in the record at this point.

[The information of Mr. Chu follows:]

STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
W. A. HARRIMAN CAMPUS
ALBANY, NY 12227

RODERICK G. W. CHU
COMMISSIONER OF TAXATION AND FINANCE
PRESIDENT, STATE TAX COMMISSION

June 16, 1987

The Honorable Thomas J. Downey
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Downey:

Since you are the sponsor of an amendment to the Tax Reform Act which will be included in the budget reconciliation legislation, I am writing on an issue of serious concern to New York and the nation. This letter will also be sent to the New York delegation and to members of the Ways and Means Committee.

As you know, I testified last July at the hearing convened by the House Committee on Ways and Means regarding gasoline excise tax evasion. You will remember that I and other witnesses explained that the problem, both at the state and federal level, was enormous and required immediate remedial action to stop the theft of hundreds of millions of dollars of tax revenues.

As a result of the record built at that hearing, Congress amended the Internal Revenue Code to provide a more efficient and effective method of tax collection. Congress moved the point of collection upstream to the refiner and the terminal operator. [Internal Revenue Code, Section 4081].

However, I understand that, under the proposed Treasury regulations being drafted to implement this change, the taxable event will, in most cases, occur when gasoline is removed from the terminal. Because title to gasoline may change hands many times within a terminal, this point of imposition creates many opportunities for tax evasion. Gasoline in the terminal may be book-transferred innumerable times, affording the opportunity for a perfect tax evasion scheme -- i.e., by running fuel through a

series of sham corporations (a "daisy chain") to obscure title and tax liability. Given New York's experience, I am gravely concerned that the proposed Treasury regulations will enable gas tax evasion to continue unabated.

New York has successfully addressed the problem of gasoline tax evasion within its borders and is in the forefront of motor fuel tax administration. Let me briefly describe the tax collection system we have adopted.

Prior to 1982, motor fuel tax was imposed when a registered distributor sold to a non-registered distributor or retailer. Sales tax was collected by the retail service stations. In 1982, the Legislature moved the responsibility for sales tax collection up the supply chain to the same distributor level as the motor fuel tax. This change was enacted because there were only about 400 to 500 such distributors in the State, and presumably it would be easier to collect taxes from this relatively small number than from the thousands of gasoline retailers. However, we found that, because these distributors controlled substantial volumes of gasoline and played a central role in the distribution chain, they were able to engage in complex "daisy chain" transactions resulting in massive tax evasion. As previously described, a "daisy chain" is the obfuscation of fuel ownership accomplished by running it through a multitude of sham corporations.

As a result, in June of 1985, New York changed the law again to establish the "first import" rule which imposed the tax at the point of importation or production. By moving collection to the top of the distribution chain, we substantially minimized opportunities to evade the tax. Indeed, we have found that the "first import" rule has been so effective that in the first year we collected $163 million in additional taxes ($90 million in excise taxes and $73 million in sales taxes). We are pleased with this success and believe that the first importation law has enabled New York to eliminate many of our problems.

I believe that Congress should take New York's experience into account in its review of the proposed Treasury regulations. While we have been in close contact with the Treasury in conjunction with the National Association of Tax Administrators' working group on motor fuel tax evasion and are communicating our concerns about the draft regulation, I believe Congress will also be interested. Since my testimony last July, industry sources indicate that criminal elements involved in the gasoline

industry have been agressively exploiting new opportunities for evading federal excise taxes. The draft Treasury regulations leave an enormous loophole for criminals to continue bilking the federal government out of substantial tax revenues.

I can assure you that moving the point of collection as far upstream as possible -- i.e., to the refinery gate or point of import -- is the most effective means to deter evasion and, at the same time, simplify auditing and tax collection.

Sincerely,

Mr. DOWNEY. Mr. DiBona, I know you wanted to get a word in.

Mr. DIBONA. Let me say that the people that I represent are the people most interested in insuring that everybody pays a tax, because we do pay ours.

And, therefore, we have a problem if other people do not pay the tax.

We have something called the State Petroleum Council up in New York, which was very actively involved in trying to insure the systems were set up so that the taxes were collected in the State of New York. These are State taxes as opposed to Federal taxes.

We are concerned that that also happened with regard to the State level. The proposal that you are making is going to benefit a few people, some of them are members of Mr. Ackell's association. It will do it at the cost of increased costs to the consumers in New York. And you should understand that that is what you are doing.

The reason that that is the case is that much of the fuel moved into New York is moved by pipeline, long distances, with substantial time element involved.

That means that if you collect the tax at the refinery gate instead of at the terminal that somehow that is going to have to be passed through. Because the margins on gasoline are very, very small.

So, the carrying costs of that expenditure are going to be passed through or there are going to be substantial reductions in stored fuel.

So, that means that people who are in places that are long distances from the refineries are going to have extra costs. Those people who are importing directly into that spot and pay at a later point in time will get a benefit from this. But the public is unlikely to get a benefit from it.

The purpose of moving it to the terminal meant that you had a very large reduction in the number of taxpayers. That has been carefully looked at by the IRS and by the Joint Taxation Committee staff.

The tax is then paid a uniform distance from the consumers in a uniform amount of time from the consumers, so it is equally levied. There is very little chance of tax evasion under the system that will go into effect on January 1 of this year.

Mr. CRANE. Mr. Archer, in your testimony you said that, "We cannot believe that many Members of Congress want to hit the working poor with a large new tax burden." What draws you to that conclusion?

Mr. ARCHER. Well, maybe it is a hope more than an expression of certainty. But from our perspective we do not think that Congress ought to be taxing the working poor or the poorest among us to balance the budget.

We do not think Congress ought to target one segment of our society, the motorist. We do not think that Congress ought to hurt the tourism and highway industries.

We think the American people are strongly against it. The latest poll says 73 percent are very against it.

Mr. CRANE. You sound like an injured taxpayer. [Laughter.]

The reason I raise that question is Mr. DiBona made reference in his testimony to a broad based tax not overly regressive or progressive.

The fact of the matter is any excise tax is regressive by definition and, in fact, a motor fuel tax is a regressive tax too.

And we already took that action back in 1983. It is up to 9 cents a gallon tax on gasoline right now and I am intrigued, though, because it goes back to something I read, oh, 40 years ago.

Mr. Buckley, I think it was, made reference to a Btu tax and a proposal I read about at that time was establishing a Btu tax at the source on all forms of energy as a substitute for all of our cumbersome and Byzantine Tax Code, which would make a lot of sense, except for one thing, and that is the ease with which taxes can be increased and a lack of public perception of how big that burden is.

I would bet the average citizen cannot tell you how much tax he is paying on a gallon of gasoline right now.

And it is a relatively painless way for politicians to raise taxes and, unfortunately, people then turn around and point the accusing finger at the manufacturers of great wealth in the business community ripping them off with extortionate profits when, in fact, there is a major tax component. In fact, we had testimony last year from the industry that the tax component of an American made car exceeds the cost of the steel that goes into that car, something, again, that I doubt the average citizen realizes.

And for that reason, while it makes a lot of good sense in terms of efficiency it is a worrisome proposal to me, because as I said, the way it is hidden, built into the cost of product and where politicians can escape the degree of direct accountability—I have always felt the taxes should be levied in the simplest way, but also the most painful possible way. So that nobody is unaware of just exactly how much he is paying. Would you concur with that?

Mr. BUCKLEY. I would certainly share that concern, Congressman Crane. I have not today advocated that you impose a Btu tax. I merely said that if tax energy you must, then try to do it in the fairest way. Let us not try to come up with a tax that is a little unfair to the east coast and then another tax that is a little bit unfair to the Midwest and the Rocky Mountains.

Let's adopt a tax that is very broad-based, and therefore, very small and fair to everybody, rather than having three taxes that are unfair to different regions and get a regional balance that way. But I do not advocate the imposition of a tax. I agree with your concerns.

Mr. CRANE. The Btu tax that you are referring to would include taxing Btu's from nuclear sources as well as gas and oil?

Mr. BUCKLEY. I think everything except nonrenewables.

Mr. CRANE. Every form of energy.

Mr. DIBONA. Could I correct the record?

Mr. CRANE. Mr. DiBona.

Mr. DIBONA. Could I correct a possible misunderstanding. When I talked about a broad-based tax, I was not talking about a broad-based energy tax. I was talking about a broad-based tax on all commodities.

Mr. CRANE. Like a national sales tax?

Mr. DiBona. We are not advocating such a tax. We are simply saying that if you need to raise revenue and if you have made a decision to raise revenue, then you should adopt a tax which minimizes the effect on the savings rate to the United States, does not discourage investment, does not disturb the progressivity or regressivity of taxation, can be imposed on imports and rebated in exports.

We would talk about the broadest base of taxation. That can be designed in a way which is not highly regressive, and certainly is not as regressive as the gasoline tax, which may be the most regressive of all taxation.

Mr. Crane. I share your concern. I, frankly, do not approve of the whole concept of progressivity, but on the other hand, regressivity in the tax law is even worse. I believe in proportional taxes, but I think that sales taxes by definition are regressive, and that is why in most States where we have imposed them, we have tried to exempt at least food and medical prescriptions in the application of the tax.

Mr. DiBona. That is one of the ways of making them not regressive.

Mr. Crane. But that is what you basically have in mind? Like a national sales tax?

Mr. DiBona. We do not have in mind any specific tax. We have got a set of principles and in looking at the alternatives that you have arrayed before you, we would use those principles.

Mr. Crane. I am not looking at those alternatives, Mr. DiBona.

Mr. DiBona. We would think that the least worst of all of those would be a broad-base sales tax. It might be in the form of a VAT or it might be in the form of a straight sales tax. But one which is as broad-based as possible and is imposed on imports, rebated in exports, which minimizes the impact on investment and encourages increases in savings in this country.

Mr. Crane. Well, let me just throw something out for your consideration. According to OMB, a 1-percent increase in GNP over a 3-year timeframe increases revenues to the tune of $47 billion. We are talking about a $65 billion package. With the application of the 1986 tax law coming into effect in 1988, it is just conceivable that might have a positive impact on business and it might even be 1 percent, it might be 2 percent, who knows.

But in addition to that, there are very reliable studies that suggest taking the capital gains tax down to 15 percent instead of the perverse escalation of that sales tax in that code could over a 3-year timeframe bring in about $31 billion. Based on past experience, that is probably a safe calculation. That would even exceed the revenues that we are talking about, and it seems to me is a sensible alternative to what the committee has under consideration now.

I would hope that we would listen to your testimony, take it to heart, and while you are not advocating a Btu tax, necessarily, nor advocating a sales tax, I hope we do not go down that garden path. I thank you all for your testimony.

Mr. Rangel. Mr. Jacobs.

Mr. Jacobs. Mr. Chairman, I think for the record that the notice sent around ought to be corrected about these hearings. The notice

implied that these hearings were on the subject of how to raise revenue. I think it is quite clear the hearings should be properly dubbed as how not to raise revenue. That is pretty much the testimony up to now, as I understand it.

There is about $2,400 billion dollars of Government spending now covered by taxes at present. I am curious. Which of your companies does long-range borrowing to pay current expenses?

Just a show of hands. Let the record show no hand is up. That is where we are. When we talk about deficit reduction, we do not talk about not sinning, we talk about sinning less. So my question to the panel is, with this $2,400 billion dollars of spending at present not covered by revenues, what is your recommendation for a program to correct that little anomaly?

What taxes do you recommend? What would you say? Would you say it should be on anything as sacreligious as income, a progressive net income tax, or would it have to be something holier, like a regressive tax? What is the opinion of the various members of the panel? Mr. Lamm?

Mr. LAMM. Let me start, and I am sure some of the other panel members would like to add on too, Mr. Jacobs.

I understood the session this morning was to talk about a much smaller amount of revenue, $20 billion to be applied in fiscal year 1988. But your point is well taken, that the testimony here has largely said that we can find reasons why a particular option found in the Joint Committee print should not be covered. And I think that was the reason we came in here.

Many of us, though, have for years testified before Congress that you should not necessarily get to this decision point. You have narrowed your choices below the point at which many of our companies came to you and talked previously. Many of our members expected and desired that the Gramm-Rudman-Hollings bill would work much more positively.

I think at this point the Ways and Means Committee has been given a nearly impossible, if not intolerable, burden. And it is because of the fact that people have not wanted to let the Gramm-Rudman-Hollings process go to the final stage of sequestration of the programs.

Mr. JACOBS. Well now, see, some of this spending cannot be cut. Do you know why? Because it has already been spent. That is about the $2,300 billion part. You cannot cut that. And so speeches about cutting spending do not count when it comes to that spending. That has to be paid, and unfortunately it can only be paid with money.

Now, does anybody on this panel think it is not a good idea to go ahead with this enormous tax cut for 1 percent for a couple for 3 percent of the American people next year, a $5.6 billion tax cut for the people who are the most privileged and have the highest incomes? Would that be sacrilegious to talk about just not granting an additional tax cut?

Mr. DIBONA. Well, Mr. Jacobs, I represent companies and that is who I am speaking for. That tax bill last year raised the tax on industry and companies, and particularly raised the rates on the petroleum industry in several ways.

Mr. JACOBS. That is very interesting, Mr. DiBona, but it hardly answers my question.

Mr. DIBONA. Well, let me continue, you asked us——

Mr. JACOBS. No. I do not want you to continue. I just want to know if anybody on the panel believes that we ought to be raising regressive taxes, $19 billion worth, partly to cover a tax cut for high-income Americans which has not even gone into effect and will not go into effect until midnight the 31st of December of the year of our Lord 1987? That is a simple question.

Does anybody believe that it is moral to raise regressive taxes in order to pay for that tax cut next year?

Mr. ARCHER. Congressman, obviously my testimony is strongly against the regressive nature of a gas tax. My dilemma is that AAA's policy positions cover taxes that affect motorists either directly or indirectly. When I gave the testimony I just did, I was speaking on behalf of an organization that has 27 million members.

If I venture into a question of other areas, such as income tax, it would just be personal opinion.

Mr. JACOBS. Let the record show no hand went up on the last question, either. I yield back the balance of my time.

Mr. PICKLE [presiding]. Mr. Gregg.

Mr. GREGG. Following up on the tactical approach of Mr. Jacobs, I was wondering if everybody who feels that an import oil fee is an appropriate approach could raise their hands so I would know who to ask questions of? Everyone who is in support of an imported-oil fee, could you raise your hands?

Mr. PICKLE. Starting up here at the table? [Laughter.]

Mr. GREGG. The record will show one person from southwest Texas raised their hand, but the gentleman from New York did not. Thank you.

Mr. DIBONA. In response to that, the position of the American Petroleum Institute is that it is an option that ought not to be ruled out, but we neither support nor oppose it at this point in time.

Mr. GREGG. Thank you. I will take that as opposition.

Mr. PICKLE. Well, the Chair will refrain from further comment, except to say that we do need to help our domestic industry and we ought to keep that in mind.

Mr. Pease?

Mr. PEASE. Thank you, Mr. Chairman. I would be interested in comments from the panel, particularly from Mr. Archer, about one proposal in the committee options book for raising funds. It is proposal No. 10, titled "Increase Trust Fund Excise Taxes to Offset Implicit General Fund Contributions to Such Funds."

It talks about two subsidies, if you will, from the general fund to the trust funds. One of them it says, "occurs because excise tax revenues displace other consumer expenditures and thus reduce taxable incomes in other sectors by an equal amount. Income taxes are thereby reduced."

In the second instance, it states "the revenue lost from tax-exempt bonds issued by State of local Governments to finance activities for which they are reimbursed with Federal Trust Fund moneys or for which the users generally are the same as those who

pay particular trust fund taxes, is not deducted from the amounts transferred from general revenues to establish trust funds."

All this relates to the fact that we transfer money, currently, from the general fund to the trust funds in the gross amount collected by excise taxes. It lists a number of those and it says that by increasing the trust fund excise tax rates 33 percent to adjust for those factors, one could raise about $5 billion a year. And to do it by an additional amount to offset revenue lost from outstanding tax exempt bonds, the revenue from the two would approximate $10 billion a year.

Are any of you in favor of that?

Mr. ARCHER. Obviously, AAA is not in favor of that. I think the key point is that the highways that that Highway Trust Fund supports has an enormous benefit for this country. Included are not only the direct benefits that often are itemized, but also the indirect benefits arising from freedom of mobility for both people and commerce. And that benefit far outweighs any indirect subsidy that can be implied by a technical argument like the one you just cited.

Mr. CHISHOLM. Mr. Pease, if I may address that point. When I saw that among the list of revenue options, I was very intrigued by it. Unfortunately, it came after a point in time we could address it from a policy standpoint with our association. But I think to some extent it goes hand in hand with some of the comments I was making earlier about the need for stronger enforcement efforts by the IRS and the proposal by the Federal Highway Administration to, in fact, help fund IRS enforcement out of the Highway Trust Fund.

I think there is a recognition there are some administrative costs, and this may be an appropriate way to do that, so long as it was limited just to the administrative costs of operating the fund, and that was generated by the same method that the fund was.

But from a policy standpoint, our association has not taken a position on it, but we will bring it to their attention at our next board of directors meeting.

Mr. PEASE. Anybody else? OK. Let me turn then back to our favorite topic with this panel, and that is the current evasion of diesel fuel taxes. Can anyone tell me how this evasion takes place? Do the retailers simply falsify their records? Is that how it is done?

Mr. CHISHOLM. If I may take a shot at that first and just say that the diesel fuel excise tax under current law is considered to be a retail tax. The retailer pays the tax to the Government, and the estimates are, there are some 80,000 to 100,000 retailers out there, many of whom, I think, legitimately are not aware they owe the excise tax. They think when they buy the diesel fuel that it is like gasoline and they have paid the tax on it. And so they may not even know they owe the tax.

So one of the proposals the Federal Highway Administration has made, which we support, is to allow distributors, or mandate that distributors collect the tax on diesel fuel.

Another problem with diesel fuel is there are far more tax exempt uses of diesel fuel than there are gasoline—off-road highway use, agricultural use, things of that nature.

The third problem is the relatively fungibility of diesel fuel with home-heating oil, and home-heating oil certainly is tax exempt. And taking that back upstream would be very, very difficult. So those are some of the difficulties in collecting all the taxes due on diesel fuel.

Mr. PEASE. Mr. Ackell, would you care to comment on that?

Mr. ACKELL. I represent IFTOA, the Independent Fuel Terminal Operators Association, and we have really not taken a position on diesel fuel. In New York, however, diesel fuel evasion has also been a problem. The lesser use created a lesser dollar amount of evasion. The problem is being addressed there in a manner similar to the way it is being addressed in the current law, which is to make the taxable event the point of sale to the retailer.

There is also in New York a proposal to identify diesel fuel by some kind of tinting program to separate that from the other uses of No. 2 oil, which can be diesel fuel.

Mr. GREGG. OK, just quickly, as we know there is a change in the law that is due to go into effect on January 1, 1988, for gasoline excise taxes. I am told by staff if we move that up from January 1 to October 1, we could pick up $100 million, roughly. Would there be any problem with your accommodating that change?

Mr. ACKELL. That is something that we would certainly endorse, the sooner the better, to eliminate evasion.

Mr. PEASE. Anybody else?

Mr. DIBONA. We are not sure that the arrangements have yet been made to bring it all about, but we would have no objection if that could be done quickly.

Mr. CHISHOLM. We would not support that, because we do have some quarrels with the way the proposal was. We agree that the point of taxation is at the terminal. We would like to work out the other concerns we have about that. Moreover, the Department of the Treasury has not even issued proposed regulations on implementing that yet. So getting the proposed regulations issued, comments accepted, and final regulations issued prior to that date, given the track record of the Department of the Treasury in this area, I think would be very, very difficult.

Mr. PICKLE. Mr. Thomas, do you have any questions?

Mr. THOMAS. Thank you, Mr. Chairman. It is as much a statement as a question.

I come from California and, obviously, it is a large geographic State, high population. But I also happen to have a district that produces more oil than the entire State of Oklahoma. So I have got all of the problems in one particular district, and it just seems to me that it is not a worthwhile exercise to sit around and talk about where the job shifts will occur under an oil import tax. The job is to lower the cost of energy to everybody who uses it in this country, and figure out a way to increase profits to the industry so that we can get more domestic production.

That to me seems to be the problem, and we ought to be looking at the tax policy—and I would call it the ill-advised tax policy—that this committee and Congress passed and the President signed, for partial relief. We ought to look at the congressional fiat that controls the movement of oil, rather than economics, within the country, principally from Alaska to the west coast, and we ought to

take a look at once again trying to get rid of the windfall profits tax that produces such silly anomalies as having people in my district, which is primarily secondary and tertiary recovery of oil, burning crude oil in the boilers to produce the steam where once they used to run bunker fuel, because if they run that oil off the property to pull the lights off for commercial purposes and bring the bunker fuel back, they have got to pay the windfall profits tax on it.

That makes it uneconomic, so they burn the crude oil in the boilers, it lowers the Btu's, increases the emissions, but it is economically sound given the presence of the windfall profits tax. Those are the kinds of things we should be focusing on instead of talking about saddling consumers, whether it be oil import fee, whether it be gasoline, or whether it be other modifications, which produces conflicts between regions, for the sake of trying to come up with some short-term revenue to cover some portion of your anatomy because you have failed to make the kinds of changes in other areas of Government spending that should be made.

So I guess I do not have a question of this panel. I would rather thank them for the testimony, try to keep us up on what is economic and sound in terms of decisions that we need to make, and I understand that New York has got some problems now. I was not fully appreciative of all of New York's problems on the taxing and the collection of oil and petroleum products in New York. But I think we ought to be focusing on the energy needs of the Nation and the fact that we are on the brink of imposing as regressive a tax as I can think of on middle-income Americans after we sold them a big bill of goods about what we were doing for them in the recent tax bill.

I cannot believe that this committee and this Congress is willing to take away so soon any marginal increment in improvement on taxation that we gave middle America by suggesting that not just one but several excise taxes be imposed on them a year after we gave them, "a little bit of breathing room."

I thank the panel for its excellent testimony.

Mr. PICKLE. Thank you, Mr. Thomas.

I thank the panel. Before you go, let me add my comments about the gasoline collection.

I beg your pardon. Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman. I also thank the panel for its extensive testimony and responses to questions.

But I think you have seen something that we are wrestling with, and it has come out very clearly in this exchange of ideas in questioning, and that is the idea that if you are from different regions of the country, like I am from Connecticut and Mr. Andrews and Mr. Pickle are from Texas that automatically we are for different things because of where we are from.

Somehow there has developed the feeling that if you are against an oil import tax, because this is really going to harm your area of the country, then you must therefore be for a gasoline sales tax. Likewise, if you are against the gasoline tax, well you are for or passive on the oil import tax.

Now I am no expert, as Mr. Thomas is, about oil and gas, but I do know that there is about 42 gallons of oil in a barrel and that if

we put a $5 oil import fee on, down the line we are going to see a 12-cent increase in the price of gasoline.

So maybe, Mr. Archer, you can help me. I have gone through your testimony and you have a very strong statement against a gasoline excise tax. Would you not also think that an oil import tax is something we should not have?

Mr. ARCHER. Well, that is an omission that I will correct. We are strongly opposed to an oil import fee. Your comments are very well taken. AAA should oppose both a gasoline tax and an oil import fee, and we do. Frankly, we were worried about a gasoline tax because an oil import fee never makes any money.

You can even make the case that over time it may even lose the Government money, if you assume, as I believe is reasonable, that if an oil import fee was imposed you would have to exempt Mexico to avoid creating a banking crisis in this country. And if you exempt Mexico, then you probably would, from a realistic standpoint, have to exempt Canada. Once you exempt Canada and Mexico, the amount of revenue that an oil import fee produces becomes de minimus.

We therefore thought that an oil import fee is not going to be imposed. Frankly, we were targeting the gasoline tax because the information we had was that a gasoline tax option was very alive, unfortunately.

Mrs. KENNELLY. Mr. Archer, by the way, I just picked you at random.

Mr. ARCHER. Sure.

Mrs. KENNELLY. You represent those hundreds of thousands of people, and I just want to bring out the point right here, that I think some of us are getting put into positions against each other, and I have seen this happen before in legislation—get people who have common interests fighting with each other, and then the common interest, the big question, is forgotten.

So I just would really hope that when you are speaking to your membership, educate them, too, that maybe some answers that look good might not be a good answer at all. Mr. Buckley was trying to explain that. Of course we are looked at—Mr. Buckley is looked at for whom he represents, I am looked at as a Member from Connecticut, and that we come from an obvious position. But there is that other more importnat fact that all States will be affected by an oil import fee.

So I just do not want us to be trapped into a position where we look like we are just being regional or being parochial, because in fact we would be weakening our own position all across the board.

Thank you, Mr. Chairman.

Mr. PICKLE. Thank you. Mr. Levin.

Mr. LEVIN. Thank you very much, Mr. Chairman. I think the testimony this morning is sobering. For those who think that it is easy to raise taxes, they ought to listen to you this morning. And to those who think legislators are just panting to raise taxes, they ought to listen to the reaction here this morning.

In that regard, let me ask if any of you want to comment further on Mr. Buckley's testimony. He backed off of it a bit in terms of a more general, excuse me, broadly based energy tax. Your testimony reads a little more enthusiastically than your comments. But do

any of you want to comment on it? In his testimony, he says, some contend that a broad-base energy tax is too complex or too difficult to administer and it need not be; imposition of an ad valorem energy tax would not be unduly difficult; it guarantees fairness to all energy consumers and regions; and most significantly, which Mr. Buckley pointed out clearly, such an across-the-board energy tax would generate approximately 10 times the gross revenue to the Treasury as an equivalent tax on imported oil.

And then Mr. Buckley concludes, if taxes—and you would underline that—on the energy sector are to be included in the budget reconciliation, only this form of energy tax should be considered by the Committee.

Mr. DiBona.

Mr. DIBONA. Well, it is clear that a broad-based energy tax has less impact upon decisions and therefore has some economic advantages over picking a particular form of energy, and from that point of view it is better than a very narrowly based energy tax. But any energy tax is going to have some very serious implications for our ability to compete in manufacturing with foreign countries. That is, whether for sales here or for sales abroad.

It is particularly acute for this country because we had very low energy prices relative to other countries for many years and as a consequence of that we have a relatively energy intensive industrial structure in this country. So we are particularly adversely affected by an energy tax of any kind, a broad-based one being less bad than a narrowly based one.

If you were going to move in that direction, of some kind of broad consumption tax, you are better off putting it on all commodities and all goods and then making sure that you exempt it on exports and you impose it on imports.

Mr. LEVIN. OK, but that is not going to happen. I mean, that kind of an ad valorem tax will not happen. So let's confine it to energy, your comments.

It is interesting, nobody here today has, I think, even mentioned the word "conservation." I mean, are we beyond the need for energy conservation in America? Maybe we are.

Mr. CHISHOLM. Mr. Levin, one of the reasons we are as strongly opposed to new energy taxes as we are is that from a conservation standpoint we think it sends the wrong message to the consumer. You see, one of the justifications we have heard for energy taxes by various people is, well, with the fall in oil prices and the fall in energy prices, consumers will not notice. We can apply a tax back to the price of oil, or something like that, and consumers are used to paying $1.10, $1.15 cents a gallon for gasoline and they will not even notice that we put the tax on.

We think that sends a very poor message to consumers, because the reason oil prices fell was because they did exactly what they were told to do. They conserved energy. And when they conserved energy, the prices fell. Now, they are rewarded by that by applying some type of energy tax on top of that, so they really have not realized any savings as a result of that conservation.

So we think an energy tax sends the wrong message back to consumers.

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Mr. LEVIN. No. The price—and I am not advocating one position or another—the price has dropped sufficiently that if you added a broadly based tax, the price today would still be considerably cheaper than a number of years ago, so I don't think you can say that we would have mislead the consumer by doing that.

Mr. CHISHOLM. I think it sends the wrong signal. Mislead may be the wrong word. I think it sends the wrong signal, but I would agree with Mr. Buckley that if there is going to be some type of energy tax, the broad-based energy tax across the board is far preferable to anything else that we have examined.

Mr. LEVIN. Does anybody else want to comment?

All right. Thank you.

Mr. Chairman, I yield back the balance of my time. Thank you.

Mr. PICKLE. Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Buckley, the reason I asked you the questions I did about the study that you have cited, is my experience here is that you can have produced for you, or discover through various methods, a study that says almost anything about any subject, and in most cases the study will be authored by an expert.

There are studies on the other side of the issue, on the oil import fee, and I just, I guess, feel that if the Department of Energy is telling us that an oil import fee is not a wise choice, when in fact the Department of Energy, as part of this administration, consistently and predictably opposes the oil import fee, that it dissipates the effectiveness of the study conclusions for me.

I happen to support an oil import fee. I think it is both good economic policy and good energy policy. Now, there is going to be great debate about that, but I happen to feel that way, and we do not have the time to explore all of the elements of it today, but I would like to see us seriously consider that as we take a look at revenue options.

Mr. DiBona, you represent an industry that in part supports that. There are parts of your industry, obviously, that would oppose it as well. But I think if you take a look at where we are in time and where we are in the world in energy supplies, you have to conclude that we are in a situation that is pretty delicate with our domestic exploration almost dead. I mean, the new regs out there are almost down to zero, and we have largely destroyed the domestic exploration side of the industry, and we need to think through how we do something about that.

Now, I would like to ask Mr. Lamm—I guess maybe tell Mr. Lamm—that the exhibit that you included with your testimony, exhibit 2, is, I think, very useful for the committee. In fact, all of the information from this panel is very good information. It describes why there is such a difference regionally on some of these issues.

Gasoline taxes, excise taxes or sales taxes on gasoline. I come from North Dakota. Well, in North Dakota we drive a lot. You have to drive a lot if you are going to get someplace where people live and where you can do business and buy groceries and so on. In New York, on Long Island, where my friend Mr. Downey lives, you know, going to Bayonne is a yearly trip. It is the biggest trip of the year. But in North Dakota, we will do that to buy groceries.

The statistics on this chart are interesting. The per capita tax, the gasoline tax in North Dakota is $147. In New York, it is $59. Now, if someone says, well, let's raise the taxes we have to raise by the gasoline tax, what do you conclude from this data, Mr. Lamm? You conclude, obviously, that they have made a choice to impose a significant burden—almost triple the burden—on people who live in my part of America versus the people who live in New York.

Well, clearly, those of us who come from that part of the country are going to say, wait a minute, that is not fair. That does not make sense. So we have got to come to grips with a regional solution—or a national solution, rather—that reconciles all of these regional differences, and it is not going to be easy at all.

But I do not think that a stiff gasoline tax increase makes sense, and I, obviously, will oppose that, for the reasons that you have so well outlined in your testimony, Mr. Lamm.

I do not have any specific questions of the panel. I think your testimony has been excellent. The information you have submitted will be very useful, but I did want to amplify on the gasoline excise tax issue, and especially demonstrate why there is such a regional difference in the impact on the consumer, or on the taxpayer, and why many of us are very concerned about that.

Mr. DOWNEY. Would the gentleman yield?

Mr. DORGAN. I would be happy to yield.

Mr. DOWNEY. I thank the gentleman. It has been my privilege to be in North Dakota. I have had to travel to Bayonne, fortunately not very often, from my home. And while it takes probably the same time as it might to travel from Long Island to Bayonne, I can appreciate the fact that in the gentleman's State that you can travel greater distances at the same time that we travel shorter distances, and that is because there are more people than sheep in New York, as opposed to North Dakota, and there are more cars than there are sheep herders, and these are regional differences of great or profound consequences, and I hope that we can work with the gentleman to convince him that an oil import fee is both bad economics, bad tax policy, and just bad for our economy in general.

Mr. DORGAN. My friend will have to be more persuasive than he has been in the past to convince me of that, but I understand that he is an expert on Midwest geography, and specifically an expert on North Dakota, and I appreciate his contribution.

Mr. DOWNEY. It is a wonderful State.

Mr. DORGAN. Thank you very much, Mr. Chairman.

Mr. PICKLE. About a year ago, or a little over a year ago, the Oversight Subcommittee of the Ways and Means Committee held an extensive hearing on the question of the gasoline evasion, particularly as it applied to New York, because the entry of organized crime had obviously created a real problem.

In the course of the various recommendations, the Department of the Treasury wanted to move the collections upstream as much as possible. The tax bill last year did say that we would make that collection at the terminal, but it would not allow marketers to be tax collectors. That was terribly unfair to the oil jobbers and petroleum marketers. It put them at a very unfair disadvantage vis-a-vis the refiners.

The Ways and Means Committee and the Senate Finance Committee recognized that and together unanimously postponed the effective date for at least a year to give us a chance to try to work out a better solution. We are trying to do that now.

The problem, really, is one of evasion. Not so much the collection, but evasion. We have been chasing a lot of rabbits here, but we ought to concentrate on the fact that we are looking at the evasion matter, and Mr. Ackell has suggested that we move collection upstream just as far up as possible, which creates some problem, particularly between the oil jobbers, the petroleum marketers, to compete against the big boys on a fair basis.

Our problem has been one of enforcement. Both the Internal Revenue Service and the Treasury simply have not enforced the laws we have, for whatever reason. It may be justified, but that has been our problem.

Now, Mr. Chisholm, if we make the oil jobbers, or the independent marketers, collectors, how can you address the evasion question? How can you satisfy that question? That is the big question we ought to be asking ourselves, not a lot of these other peripheral regional questions.

Mr. CHISHOLM. I think the issue, as you correctly pointed out, is one of evasion and I think the way you solve that is by defining clearly the point of taxation, which last year's tax bill did, and we have no quarrel with it. The point of taxation should be the refiner terminal. Our quarrel is who should pay the tax at the terminal, and our members, because they are in a competitive situation in the retail market, would like to be able to remit the tax directly to the Treasury, and if you allow the terminal to be the point of taxation and you force my members to pay the tax on the purchases, then you have a closed system that is easily auditable and easily trackable.

Furthermore, if you force them to demonstrate financial responsibility that they can meet their tax exposure, their tax liability, I think you have created an ideal system in terms of ending evasion. Evasion would be very, very difficult under that format. But you make an excellent point that the only way evasion will ever be stopped completely is for the IRS and the Treasury to demonstrate a much stronger commitment to enforcement than they have demonstrated in the past, than we have seen them demonstrate recently.

Mr. PICKLE. Well, not only in enforcement, with which I agree, and I think everybody would agree on that, because we need more vigilance in this area, but we also need to know what is expected of a collector or a marketer as far as financial responsibility is concerned.

Now, that ought to be determined. If that can be determined, then that answers most of the questions that we have here. I do not want to see us get into situations where we just literally squeeze the independent marketers and put them out of business, and if we are not careful, that is what is going to happen. Dozens and dozens of Members of the House have protested to keep that from happening. We ought to protect the marketers. I do not disagree with moving collections upstream, but there is a point

beyond which you can go that it will be unfair, and we have got to be certain that we do not do that.

So I insist on concentrating on the evasion question and enforcement, more than just the point of collection. I do not want to say the Treasury is lazy, but if they had 50 places to collect taxes, that would be simple and easy for them, but it sure would be difficult for hundreds and perhaps thousands of people who deal in this.

Now, I want to say additionally, the Oversight Subcommittee is going to have additional hearings on this question and we are going to approach, also, questions of diesel fuel and aviation fuel. The full committee has directed us to look into this further, so we will be looking. This is not just a one-shot proposition to try to, "raise some revenue."

We have got to have some fairness in it at the same time. So I just wanted to make that observation to you people who want to simplify it. There are other problems than simplification.

I thank the panel very much. We appreciate your testimony.

If you members of this panel No. 2 would please take your places at the witness table.

The Chair would want to recognize this panel. George Schofield is consultant for the Winegrape Growers of America, and I understand you're accompanied by Becky Murphy—Ms. Murphy. And is John Martini with you also?

Then the other members of the panel are Mr. Douglas Metz, executive vice president of the Wine & Spirits Wholesalers—Mr. Metz. And then Michael Jacobson, coordinator of the National Alcohol Tax Coalition—Mr. Jacobson.

Mr. Schofield, if you'll proceed first. All of your statement will be included in the record.

STATEMENT OF GEORGE SCHOFIELD, CONSULTANT, WINEGRAPE GROWERS OF AMERICA, INC., ACCOMPANIED BY BECKY MURPHY, CHAIRPERSON, WINEGRAPE GROWERS OF AMERICA, INC.; AND JOHN MARTINI, PRESIDENT, NEW YORK WINE GRAPE GROWERS ASSOCIATION

Mr. SCHOFIELD. Thank you. My entire printed statement will be for the record, and I can orally highlight it.

I am a witness for the—my name is George Schofield, and I am witness for the Winegrape Growers of America, which is a federation of State associations representing a large majority of the vineyard owners in the United States. With me is Becky Murphy from Texas, who is the chairperson of the Winegrape Growers of America; and also John Martini, who is the president——

Mr. PICKLE. Who was that last one you——

Mr. SCHOFIELD. Becky Murphy from Texas.

Mr. PICKLE. Ms. Becky—from Dallas, TX? Well, we'll welcome her.

Mr. SCHOFIELD. And she is the chairperson of our association, and also accompanying me is John Martini, who is the president of the New York State Wine Grape Growers Association.

Our membership of the Winegrape Growers of America has a basic concern about the proposed table wine excise tax increase in that we don't believe it's going to generate a significant amount of

tax dollars and that the net impact will be one where the consumer price resistance and the oversupply of grapes and wines in the United States will cause severe impact at the farm level. We feel that this is a poor option at this point in time and would like to discuss our logic with you.

First I'd like to go back and talk a little bit about the background of the wine industry and particularly the vineyard industry in the United States.

There's a misconception that this is a large industry, and taking New York as an example, we believe that it's primarily composed of a small group of owners in a relatively small industry. In New York there's 1,500 growers who own collectively 38,000 acres, which averages out to be about 25 acres per person. Texas has a fledgling industry which is just getting off the ground. It represents about 400 growers who own collectively about 4,500 acres of land—a little more than 10 acres per person. So the misconception of being large is one I'd like to dispel.

It takes about $6,000 per acre to develop a vineyard in the United States. It takes 3 years before you get the first crop and another 3 years before the vineyard is fully mature. Vines and grapes essentially are not a row crop—something that you can rotate. Once they're in the ground, it's a long-term investment.

The grapes themselves—it should be pointed out most of the wine grapes which we're concentrating on have seeds. This generally indicates that they are suitable only for juice, and that juice becomes a basic component of an agricultural product called wine which is subject to natural fermentation. One hundred percent of the juice generally—in fact, in all cases—winds up in the end product. And as a result there's a direct interdependence of the economics on the farm and the economics in the wine industry and vice versa.

In regard to the wine excise tax—in 1986 $270 million was generated from the wine industry, $150 million of which came from the low volume, highly taxed sparkling wine/champagne wine category. Only $68 million came from the U.S. domestically produced table wine market, and we feel that that is a low base to work from in terms of tax generation. And particularly when you consider the secondary and tertiary effects on the economy and the farm communities, we feel that the net impact is going to be very, very minimal.

We would like to call to your attention a USDA study, done by Assistant Secretary Robert Thompson and submitted in response to Senator Wilson's inquiries, which points out that there is an adverse impact of two times the increase in excise tax back to the farmers and to the farm community. And for this reason, we think that when you start with that low base and net down the secondary and tertiary impact, we're going to wind up with a very, very minimal impact.

The second thrust of our testimony deals with the consumer price resistance. The wine industry since 1981 has been characterized by weak demand and oversupply, particularly if you exclude the premium wine section, which is very small—perhaps 10 percent of the volume section—and the cooler section, which although representing 25 percent of the volume and rapidly growing, is only

composed of 50 percent equivalent to wine and—particularly from our viewpoint—50 percent grapes. Citrus and other products are generally blended in.

The backbone of the table wine business is down about 7 percent in 1985 versus 1986, as you look at the volume numbers. And worse than that, the industry has been characterized by price weakness. If you take a look at the Consumer Price Index from Bureau of Labor Statistics numbers, the overall industry has been essentially flat since 1983 in price performance while the consumer price index generally has gone up about 11 percent. And more particularly, the backbone of the industry, the white generic product, shows a decrease of 7 percent versus the base of 1983 when the series started.

Conforming with that argument on price resistance at a consumer level, we see the impact of higher prices on the imports. In the past year foreign currencies have been very strong, and particularly the French franc has gone up about 40 percent, and we see that their volume has dropped about 30 percent.

So we think a strong argument can be made that the impact on the excise tax increase will largely fall back to processors and particularly to farmers. And when you look at the processors' side of it, there was an interesting study by the U.S. International Trade Commission relative to countervailing tariffs on imports which demonstrates that 8 of 10 nonpremium table wine producers in California have lost money in 1984. The prospects for them in 1985 and 1986 have not really improved very much except for the cooler component, which again is very small and not entirely composed of grapes.

So we think we're looking at a classical agricultural problem of oversupply created by bumper crops, overplanting in 1978–81, and also the result of weakness in demand.

Moving on to talk a little bit about the growers in particular—since the processors and the consumers are not likely to pick up the costs of the excise tax, we would like to emphasize that unlike France and Italy, the growers and the wine producers in the United States are not subsidized in any fashion whatsoever, nor are they protected by tariffs or any other trade barriers. They stand alone. And we look at the economics—particularly in the New York situation where a Cornell study in 1984 showed that producers of Concord grapes were losing $568 an acre, and the producers of Delaware grapes $365 an acre—we look at a very severe economic problem today on the farm before any additional excise taxes are considered. California is in the same situation.

There's a chronic surplus of raisin variety, grapes which are used for wine: French columbard and chemin blanc. The price of Thompson seedless grapes for wine purchasing has dropped down to a $75 per ton level in 1984 and 1985 versus a $200 level in 1981—a 60-percent drop or more. In 1986 it recovered to about $105, which is hardly above the 1977 price. When you look at the out-of-pocket costs of farming—taking a 10-ton breaker yield times $105 cost revenue, it represents about a $1,050 of revenue versus out-of-pocket costs which range between $1,000 to $1,100.

So essentially, before servicing any debt whatsoever, the farm situation today is at a break-even.

When we look at the possibility of absorbing additional excise tax back to the growers, which we think is a realistic economic situation, the 17 cents current tax on wine converts back to a $30 per ton hit back to the growers if we talk about raising it again to that extent. The economics of such an absorption of costs is such that we feel that it will push many of the small vineyards and farms in vineyard ownership into foreclosure and bank problems. The reality of that situation, I think, has been demonstrated very well in the past year.

In summary, we feel that the proposed excise tax increase is not a meaningful enhancement of tax revenue. And particularly when you net out the immediate and secondary effects, it could well be counterproductive. A large majority of that impact is likely to be passed back not to consumers and not to the processors because of their inability to absorb it but back to the farm, contributing to further farm deterioration.

We therefore conclude that it is really a poor alternative for revenue enhancement and that from a farm economy point of view, the timing of it is really dreadful.

Thank you, Mr. Chairman.

[The statement of Mr. Schofield follows:]

Testimony by

George Schofield

on behalf of

WINEGRAPE GROWERS OF AMERICA, INC.

Mr. Chairman,

The Winegrape Growers of America, Inc., (WGA) is a federation of state winegrape grower associations. These states in turn represents a majority of the vineyard owners in the United States. Currently there are some thirty eight states involved in winegrape production. Our chairperson is from Texas, the vice chairperson is from California, the secretary is from Ohio, and the treasurer is from Virginia.

The purpose of WGA is to represent the state associations on federal issues and to provide a forum for an exchanges of information between the different state associations.

I am appearing today because the state associations are greatly concerned about proposals to increase the federal wine excise tax.

Let's briefly look at the vineyard industry. It requires three years of development before first production of winegrapes begins and six years before full production. A vineyard is a permanent crop and unlike field or raw crops yearly rotation is not possible. Grapes are extremely perishable and unlike other commodities their uses are limited.

These family-run vineyard operations are like farmers everywhere -- they are already deeply in debt and one bad year could mean the difference between solvency and foreclosure. It costs about $6,000 an acre to establish a vineyard. Unlike an industrial operation, a vineyard cannot be put into storage, nor can the crop be simply plowed under like corn, wheat and other agricultural commodities. If the vineyards are abandoned or lost, they cannot be resurrected the next year without great financial inputs. Except for California, where some grapes can be used for raisins or table grape production (although this causes distortions in the raisin and table grape industries), winegrapes must be used for juice.

I remind this Committee that the winegrape industry does not have government subsidies or other Federal programs to fall back on. However, many vineyards are in areas where other crops are subsidized. Consequently, the winegrape growers must compete for labor, farm supplies, and land without the benefit of these subsidies.

In addition to the new problems this tax will cause for winegrape growers, this panel should consider several

connected issues. For one thing, winegrape growers and small vintners have been responsible for the growth of a vibrant tourist trade in many rural areas, supporting bed and boards, hotels and restaurants. The death of these small vineyards, and the revenue they generate, would be catastrophic for many small businesses.

The source of the wine is the juice of an agricultural product -- the winegrape. Hence, farmers are major participants in the wine industry and in turn are extremely sensitive and dependent on the overall economic conditions of the wine industry.

The wine industry since the end of 1981 has been suffering from heavy planting in the 1978-1981 period, oversupply related to bumper crops, and foreign competition. The industry at a consumer level has been plagued with stagnation in volume and weakness in prices, particularly for traditional generic wines made from grapes. Wine coolers, which generally contain less than 50% grape content, and the very small premium wine markets have shown some strong growth, but the high volume generic wine business has been declining in volume. The white generic table wine segment of the industry, which accounts for about 50% of all wine sold, has been unable to increase prices sufficiently to offset inflation.

The total of all wine excise taxes including imports produced an estimated total of $270 million in federal tax revenue in 1986. Over $150 million of the revenue (55%) was generated by the relatively high tax on the low volume sparking wine category. In 1986, the domestically produced table wine category generated an estimated $68 million in tax revenue. Because of this low base and because of the current dire economic conditions in the table wine and grape industries, the table wine excise tax is a poor revenue option at this time.

State wine excise taxes are higher than other alcoholic beverages in all the states except for three.

According to the Bureau of Labor Statistics, the Producer Price Index for white generic table wine prices in April 1987 was 7.4% lower than December 1983, the starting point for the series. Any increase in tax will have a further negative effect on the market and income. Rather than increase operating losses, it should be expected that some wineries, like any other businesses, would attempt to offset higher taxes by lowering raw material costs simply because they are competing against imported wines which receive government assistance and the resulting surplus of grape juice in the domestic market.

The U.S. International Trade Commission Report

(Publication #1771, October 1985) on countervailing duty relative to imported wines indicated that eight of the ten largest producers of non-premium table wines experienced operating losses in 1984. With no significant improvement occurring since then, with the exception of the separate wine cooler category, grape growers would undoubtedly be forced to absorb much of the impact of any excise tax increase in the form of lower grape prices. Accordingly, rather than a "wine excise tax" the increase would become a "farmer's tax", caused by the resulting wine surplus and the increased excise tax.

Equally alarming is the economic condition of the New York state winegrape vineyard owners. In a 1984 study the growers learned that they suffered a loss on all varieties of winegrapes harvested. On concord grapes they lost an average of $568 per acre and lost $365 on the Delaware variety of grapes. Please note this does not include mortgage interest, but only production costs. I estimate another $180 per acre cost can be added to the above losses per acre. Similar results were experienced by growers in Pennsylvania.

Growers of Thompson Seedless, French Colombard, Chenin Blanc, and other generic grapes are the backbone of the U.S. table wine business. Unlike grape growers in France and Italy, U.S. grape growers receive no government subsidies, nor have they received any significant protection in the form of tariffs or trade barriers. In the absence of such support, the level of wine excise tax becomes a critical economic factor to the grape grower. With today's financial crisis on most farms, the grower can ill afford to absorb any additional costs.

Prices for generic table wine grapes in California can be characterized as severely depressed. Average prices for Thompson Seedless grapes in 1984 and 1985 were 60% below the 1981 peak levels and 50% below the levels of 1978 to 1980. Although recovering somewhat, the 1986 average price of $105 per ton paid by wineries was hardly above the 1977 price level and was below the current break-even point for most growers.

The current table wine excise tax of 17 cents per gallon converts to close to $30 per ton. The average 1986 price of Thompson Seedless, Chenin Blanc and French Colombard grapes in California was $131 per ton. With ten tons per acre yields, most growers of such grapes cannot cover their out-of-pocket farming costs, and growers with any significant debt are unable to service interest charges. Any significant increase in the wine excise tax, therefore, will aggravate a serious agricultural financial problem and increase farm foreclosures.

In reviewing the Joint Tax Committee staff revenue options pamphlet we noticed the absence of the U.S. Department of Agriculture's April 1986 analysis of an increase in the federal wine excise tax on the grape and wine industry (attached). Some of the federal government findings were:

- a scale back by the industry caused by the increased wine excise tax would cost the economy as a whole more than the likely increase in revenue.

- if an added excise tax increase of $.17 to $.87 was passed back to the producer, it would be the equivalent of $115 per ton of grapes on two thirds of the price received by growers over the last several years, and

- the likely $650 million loss if the wine excise tax is increased to the above amount was enacted compares with added excise tax revenues of possibly $350 million.

Unfortunately winegrapes do not have to be grown in the United States. The world surplus of wine is monumental and since the U.S. has no quotas and relatively low tariffs compared to other non-EEC nations, the U.S. is an excellent market for foreign wines.

We have all heard of or watched the program Falcon Crest. This program portrays a region of California that has been just as successful as the appellations in France known as Bordeaux and Burgundy. Unfortunately for the winegrape growers these appellations are unique. This probably represents less than three percent of the nation's production. Almost all of our wine is known as bulk or ordinary table wine and this is where any increase in wine excise tax will fall the heaviest on the low and middle income families because the excise tax does not discriminate between the wines.

In summary, a large scale sudden increase in wine excise tax would not generate a meaningful enhancement of total tax revenue. If enacted, any increase is likely to be passed to the consumer in higher prices and would result in lower grape prices to the farmers. The result is likely to be a further deterioration in the financial plight of grape growers and increased farm foreclosures.

Winegrape Growers of America

Winegrape Growers of America, Inc., (WGA) is a federation of state winegrape grower associations.

Officers

Becky Murphy
Chairperson
Texas Grape Growers Association

Aram Kinosian
Vice Chairperson
California Association of Winegrape Growers

Donnie Winchell
Secretary
Ohio Wine Producer's Association

Doug Flemer
Treasurer
Virginia Wineries Association, Inc.

Member States

Arizonia Wine Growers Association

California Association of Winegrape Growers

Idaho Winegrape Growers

Maryland Grape Growers Association

New Mexico Wine and Vine Society

New York Wine Grape Growers

North Carolina Grape Growers Association

Ohio Wine Producers Association

Oregon Winegrowers Association

Pennsylvania Grape Industry Association

Texas Grape Growers Association

Virginia Wineries Association, Inc.

Washington Association of Wine Grape Growers

West Virginia Grape Growers Association

ESTIMATED WINE EXCISE TAX

	Wine (gals in millions) Entering Distribution Channel in US			Current Tax Rate $/Gal	$ Million Estimated Tax Revenue		
	U.S. Produced	Imports	Total		U.S. Produced Wine	Imported Wine	Total
Table Wines	399	89	488	$ .17	$ 68	$ 15	$ 83
Dessert & Vermouth	49	6	55	.67	33	4	37
Sparkling Wines	30	14	44	3.40	102	48	150
Total	478	109	587		$203	$ 67	$270

New York State Winegrape Study
1984

Income

Concord Grape

Yield: 4.64 tons per acre
Price: $177 per ton = $821 per acre

Delaware grape

Yield: 3.24 tons per acre
Price: $316 per ton = $1,024 per acre

Expenses
*Production costs per acre $1,389
(mortgage interest not included)

Profit or (loss)

Concord ($568)
Delaware ($365)

CHANGE IN TABLE WINE PRICE INDICES

	Dec. 1983	Dec. 1986	Average 3 Year Change	April 1987
White Table Wines - Generic (1)	100.0	90.8	(3.1)%	92.6
Grape Table Wine (1)	100.0	99.6	(0.1)%	103.3
Alcoholic Beverages (1)	100.0	105.9	+2.0%	107.0
Consumer Price Index	100.0	109.1	+3.0%	111.3

(1) Producer Price Index, U. S. Bureau of Labor Statistics

1986 California Grape Crush

	Tons (000)	$/TON	$Millions
Thompson Seedless	445	$104	$ 46
Chenin Blanc	301	159	48
French Colombard	677	136	92
Subtotal	1,423	$131	$186
All Others	1,370		334
Total Crushed	2,793	$186	$520

PRICES BY MASSACHUSETTS WHOLESALERS
GENERIC - 3.0 LITER SIZE

($/CASE)	$/CASE AFTER REVENUE SEPT/OCT 1986	SEPT 1982	% CHANGE
CRIBARI	$18.20	$19.10	-5%
COLONY	18.36	20.80	-12%
CARLO ROSSI	15.45	19.20*	-20%
GALLO	17.90	20.05	-11%
ALMADEN	21.85	27.20	-20%

*NO REVENUE

TOTAL SHIPMENTS OF ALL CALIFORNIA WINES
TO ALL MARKETS
GROWTH %

	TOTAL AS PUBLISHED	EX COOLER	WITH WINE CONTENT OF COOLER
1981	+5.8%	+5.8%	+5.8%
1982	+0.1%	+0.1%	+0.1%
1983	+1.4%	(0.3%)	+0.6%
1984	+2.6%	(3.3%)	(0.3%)
1985	+5.0%	(3.2%)	+1.1%
1986 PROJ.	+8.0%	+2.8%	+5.6%

CENTRAL VALLEY VINEYARD

CHENIN BLANC

$/ACRE	
REVENUE (10 TONS @ $125)	$1,250.
OUT OF POCKET FARMING COSTS	800.
ADMINISTRATION EXPENSES	200.
VINE REPLACEMENT	
TOTAL COSTS	$1,000.
OPERATING PROFIT BEFORE INTEREST	$ 250.
VINEYARD VALUE PER ACRE	?.

RAISIN GRAPES - 1987

	BEARING ACRES	NORMAL CROP (TONS)
TOTAL SUPPLY	276,540	2,410,000
UTILIZATION		
Dried Raisin Market		1,440,000 tons
Canned and Table Markets		390,000
Balance		580,000 tons
Wineries		500,000
Surplus		80,000
		3%
Diversion Program		135,000

RAISIN GRAPE ANALYSIS

	Price ($/ton)	Yield Tons/Acre	Per Acre	Planted
1976	$ 85	8.2	$ 697	2,301
1977	100	8.0	800	3,845
1978	153	7.0	1,065	7,494
1979	150	9.7	1,449	12,193
1980	144	11.0	1,585	15,396
1981	200	7.1	1,416	10,742
1982	127	10.1	1,281	8,281
1983	104	8.9	920	4,519
1984	78	8.0	626	2,569
1985	75	9.2	683	803
1986	105	8.8	924	613
1987	120	8.8	1,056	1,000

DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

April 29, 1986

Honorable Pete Wilson
United States Senate
Washington, D.C. 20510

Dear Senator Wilson:

Thank you for your recent letter requesting Department analysis of the impact of the Senate Finance Committee's Tax Reform Bill on the grape and wine industry.

The bill contains three provisions that would affect the industry. It calls for:

- o Elimination of excise tax deductibility for Federal income tax purposes;
- o Indexing of excise taxes on alcohol, tobacco, and fuel; and
- o An increase in the excise tax on wine to make it equivalent to the excise tax on beer on a per unit of alcohol basis.

The first two provisions would affect the grape and wine industries along with all other industries subject to Federal excise taxes. Their impact would be possibly more significant than the impact of excise tax equalization, but neither provision would impose any unique burden on the industry.

The third provision, however, would put a special burden on the grape and wine industry. Under current law, wine containing less than 21 percent alcohol is subject to a tax of approximately $5.50 per barrel. This rate is substantially lower than the rate for beer, particularly if the two are compared on an alcohol content basis. The differences in rates has traditionally been justified in part on the basis of industry claims that wine is used as more than an alcoholic beverage. Assuming beer is 4 percent alcohol, the typical beer tax of $31 per barrel is the equivalent of a tax of 7.25 percent per 1 percent of alcohol per gallon. The typical table wine with a 12 percent alcohol content is taxed at less than 1.5 percent per 1 percent of alcohol per gallon. The Senate Finance Committee's proposal raises the tax rate on wine to equal the rate on beer. This would increase the tax on table wine, the category most seriously affected, from 15-20 cents to 85-90 cents a bottle. This is the equivalent of a 10 percent increase in retail prices.

While it is difficult to forecast how much of the added tax would be passed backward to producers or forward to consumers, the adjustments involved in either case are significant enough to raise serious questions. If the tax increase were passed back to winery and vineyard operators, it would add to pressure on an industry faced with serious excess capacity problems. If passed forward to consumers, the tax would reduce demand for wine enough to

force the industry to scale back. Given the industry's links to other sectors of the economy, a scale-back could cost the economy as a whole more than the likely increase in revenue.

If all of the added tax in question was passed back to producers, it would be the equivalent of $115 per ton of grapes or two-thirds of the price received by growers over the last several years. Clearly, all of the tax could not be passed back to producers despite supply and demand elasticities that suggest growers would normally absorb all or most of the adjustment.

If part or all of the added excise tax were passed on to consumers, the impact on the industry would be somewhat less, but the tax would reduce economic activity outside the sector more than enough to offset any lessening of pressure on the grape and wine industry. A 10 percent increase in the retail price of wine would reduce wine demand 5-6 percent. Assuming such a reduction was spread evenly between domestic and imported wines, U.S. wineries would loose up to 24 million gallons of demand and vineyards would loose a market for 150,000 tons of grapes. This industry loss would affect activity well beyond the sector. Industry economists estimate employment in grape and winery operations at more than 200,000 and suggest that every dollar in activity at the vineyard level ultimately generates another $1.86 in activity while $1 at the winery level ultimately generates another $2.20 in activity.

Given these linkages, the loss of 150,000 tons in grape sales would translate into a $90-million decline in grape sales and related activity up to the vineyard level. The tax would also reduce sales at the winery level $175 million; a loss in winery activity of this magnitude would reduce overall activity in the economy $560 million. Hence, losses at the vineyard and winery levels combined with associated losses elsewhere in the economy could total $650 million.

While the industry data used to generate these impact estimates may overstate vineyard and winery linkages to the rest of the economy, their estimates are comparable to estimates made in university and government circles. The $650 million loss likely if the equalization provision were passed compares with added excise tax revenues of possibly $350 million. The industry's total tax burden with the new provision in place would increase to more than $650 million.

I hope this information is helpful.

Sincerely,

Robert L. Thompson

ROBERT L. THOMPSON
Assistant Secretary
for Economics

Mr. RANGEL. Thank you, Mr. Schofield. Mr. Metz.

STATEMENT OF DOUGLAS W. METZ, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, WINE & SPIRITS WHOLESALERS OF AMERICA, INC.

Mr. METZ. Thank you, Mr. Chairman.

Members of the committee, I am Doug Metz, executive vice president and general counsel of the Wine and Spirits Wholesalers of America—WSWA. The 725 company members of our association represent approximately 90 percent of the sales of wholesale of wines and spirits in the 32 licensed States, the District of Columbia, Puerto Rico and the Virgin Islands, and in over half of the 18 controlled States where wine can be wholesaled under license.

We join with the wine, spirits, and beer industries in opposing any increase in Federal taxes on alcohol beverages. We also associate ourselves with the testimony of the Distilled Spirits Council against proposals in the revenue options pamphlet such as indexing, elimination of the deductibility of advertising expenses, and the taxation of blenders such as wine and alcohol derived from flavors at the rate for distilled spirits, all of which would increase the present heavy tax burden on alcohol beverages.

Mr. Chairman, our members are not giant companies. Half of our members have annual sales under $10 million. Yet collectively we pay over $1.3 billion in State excise taxes, and since 1951 the States have increased these taxes by over 700 percent. Wholesalers also pay significant amounts of Federal excise taxes. Since we directly import a majority of the bottled wines and spirits entering the United States, we remit more than $300 million annually in Federal taxes and duties, and last year we paid more than $100 million in floor stock tax occasioned by the 1985 increase in the Federal excise tax on distilled spirits.

This escalating tax burden, combined with lifestyle changes in drinking habits, have resulted in the greatest economic crisis in our industry since repeal of prohibition in 1934. For example, spirits sales have declined each year for the past 6 years. Table wines sales have declined by 6 percent in the last 2 years. Industry employment continues to shrink—over 5 percent in 1986. In the last 2 years our association membership declined by 15 percent.

There is growing evidence that the taxation of the alcohol beverage industry amounting to $12.5 billion in Federal, State, and local taxes has reached the saturation point. Tax increases are not generating estimated revenues, and many states are actually experiencing revenue declines. Alexander Hamilton foresaw this when he warned us in Federalist Paper No. 21 that consumption taxes prescribe their own limit, which cannot be exceeded without defeating the end proposed—that is, the extension of the revenue.

When applied to this object, the saying is as just as it is witty that in political arithmetic, 2 and 2 do not always make 4. If duties are too high they lessen the consumption, the collection is eluded, and the product to the Treasury is not as great as when they are confined within proper and moderate bounds.

It is time for the Congress to recognize that perpetuation of excise taxes at the Federal level is archaic and unwise tax policy.

When prohibition was repealed in 1934, the Federal Government depended on excise taxes for 46 percent of its total revenue. Today that number approximates 4 percent. The Congress should accelerate the trend toward reliance on broad-based, nondiscriminatory taxes as revenue generators and leave selective excise and sales taxes to the states, which depend on them for about 17 percent of their total income.

The regressive character of excise taxes offers another justification for their demise in Federal tax policy. Products and services subject to these taxes cost low-income consumers proportionally more than those with higher incomes. Three recent studies conducted by congressional and outside groups confirm that excise tax increases can, depending on their magnitude, completely negate the savings for low income consumers from last year's tax reform.

Chairman, the desired effect of those seeking higher prices as a way of tempering consumption by abusive drinkers and young drinkers is not to be realized. When tax increases trigger price increases for alcohol beverages, tens of millions of moderate drinkers cut back. But the problem drinker doesn't. Overall demand for alcohol beverages falls—together with tax revenues—but the thirst of the alcoholic or abuser is not slaked. Those consumers who drink moderately and who thus may actually benefit physically from modest consumption pay a price penalty.

The folly of using tax increases to cure social ills like abusive consumption and the disease of alcoholism has been documented. In the Soviet Union, for instance, where such increases in prices were tested, it did not work. Former Premier Nikita Krushchev in his memoirs reported that the only effect of increasing the price of vodka was to make it more expensive for the poor man to buy. Consumption by alcohol abusers wasn't affected.

Thus the term "sin tax" is a cruel misnomer, Mr. Chairman. The saints are punished, and the sinners are not deterred. The only sin is the Federal tax itself—repressive, unfairly discriminatory and punitive, and a debilitating encroachment on a source of revenue more vital to the States than to the Federal Government.

Mr. Chairman, one more chapter in tax reform needs to be written by this committee—the abolition of Federal excise taxes in favor of broader-based and less discriminatory forms of business taxation.

Thank you very much.

Mr. PICKLE. Mr. Metz, thank you for that clear exposition of your position.

Mr. Jacobson.

STATEMENT OF MICHAEL F. JACOBSON, PH.D., COORDINATOR, NATIONAL ALCOHOL TAX COALITION, AND EXECUTIVE DIRECTOR, CENTER FOR SCIENCE IN THE PUBLIC INTEREST

Mr. JACOBSON. Thank you very much, sir. Good morning. Thank you for the opportunity to testify.

My name is Michael Jacobson. I'm the executive director of the Center for Science in the Public Interest, a nonprofit organization that advocates improved health policies. But I'm also here as the coordinator of the National Alcohol Tax Coalition, which is com-

posed of over 60 national and local nonprofit organizations, including the American Association of Retired Persons, the National Council of Alcoholism, and the American Nurses Association. The Coalition has published a report on excise taxes which we would like to submit for the record.

To get right to the point, we urge Congress to raise excise taxes on alcoholic beverages. Specifically, the coalition supports doubling the tax rate on hard liquor and then raising beer and wine taxes to that liquor rate according to alcohol content. These changes would generate an estimate $12 billion annually in new revenue. Just raising beer and wine taxes to the liquor rate without changing the liquor rate would raise almost $5 billion annually.

Federal excise taxes on beer and table wine were last raised in 1951. The tax on liquor rose 19 percent in 1985 but still lags way behind the 335 percent cost of living increase that has occurred since 1951. This graph shows how the real value of alcohol taxes has been eroded by inflation, this being liquor, this being wine, and beer way down here practically—not making it off the bottom of the chart. All the rates are at or near the lowest they've ever been since the repeal of Prohibition.

The failure of alcohol taxes to keep up with inflation has cost the U.S. Treasury upwards of $80 billion since 1951. The graph also shows how much lower beer and wine taxes are than the liquor tax. The alcohol and beer is taxed about one-fourth the rate of liquor, and wine about one-seventeenth the rate. The Federal tax on a can of beer is only about 2½ cents; on a glass of wine, less than a penny; and on a shot of whiskey, something like 10 to 15 cents. Each of these would contain about the same amount of alcohol.

These differentials make no sense at all. Liquor may be the most concentrated form of alcohol, but beer is the favorite drink of drunk drivers and teenagers, and low-income alcoholics often choose fortified wine, the cheapest source of alcohol. All alcohol, regardless of beverage type, should be taxed at the same rate.

In addition to boosting the tax rates, Congress should index the rates to inflation. As the Treasury Department testified last year at the Senate Finance Committee, the alternative of having fixed rates slowly eroded by inflation is on balance undesirable. "We thus support the chairman's proposal to adjust tax rates for inflation."

Notwithstanding the public's general and understandable opposition to tax hikes, there's remarkably broad support for raising alcohol taxes. A June 1987 Washington Post/ABC News poll showed 75 percent of the public in favor of raising alcohol and certain other excise taxes. Last year the Treasury Department supported the excise tax increases. The Washington Post, New York Times, and L.A. Times have all editorialized in support of higher excise taxes. And dozens of distinguished economists, including Lester Thurow, Martin Feldstein, Joseph Pechman have supported substantially higher excise taxes.

While the alcoholic beverage industry fears that higher taxes would reduce its profits, it's worth emphasizing that alcoholic beverages—like cigarettes—differ greatly from virtually all other products. According to Government statistics, the grim yearly toll from

alcoholic beverages amounts to over 100,000 lives lost and about $120 billion a year in economic harm.

Economists have developed impressive evidence that tax increases would be highly effective in reducing health and safety problems related to alcoholic beverages. The tax increases that our coalition advocates would likely reduce the costs related to alcohol abuse by about $16 billion annually, regardless of what Nikita Krushchev said a number of years ago. I think Chairman Gorbachev might be a more interesting person to testify with regard to alcohol issues.

The alcoholic beverage industry has alleged that tax increases would hurt low-income consumers the most. That's a specious argument that should be disposed of once and for all.

Several factors clearly distinguish alcohol taxes from other excises taxes. First, alcoholic beverages are relative luxuries—not essentials like telephone service or gasoline. Second, low-income households are much likelier than higher income households to abstain from alcohol completely. Third, among drinking households, upper income ones spend over twice as much on alcoholic beverages as lower income ones. Lower income persons spend an average of only 3 percent of their total expenditures on alcohol.

The fact that organizations devoted to the interests of the poor, such as the Children's Defense Fund and American Association of Retired Persons are four-square behind higher alcohol taxes suggests that there's less to the regressiveness argument than first meets the eye.

In conclusion, let me just reiterate that the time has come to double the liquor tax, boost beer and wine taxes to the liquor rate, and then mandate periodic adjustments for inflation. Doing so would constitute sound economic policy and would confer valuable health dividends.

That concludes my statement. Thank you once again.

[The statement of Mr. Jacobson and a study submitted by the National Alcohol Tax Coalition follow:]

Hearings on Revenue Increase Options
Committee on Ways and Means
July 9, 1987

TESTIMONY OF MICHAEL F. JACOBSON, PH.D.
NATIONAL ALCOHOL TAX COALITION
c/o CENTER FOR SCIENCE IN THE PUBLIC INTEREST
1501 16th Street, NW
Washington, DC 20036
202-332-9110

My name is Michael Jacobson. I am executive director of the Center for Science in the Public Interest (CSPI), a non-profit organization that advocates improved health and nutrition policies. CSPI is supported largely by its 80,000 members throughout the United States.

The Center coordinates the National Alcohol Tax Coalition (NATC), a group of 30 national and dozens of state and local organizations. Coalition members include the American Association of Retired Persons, the Association of Junior Leagues, the National Council on Alcoholism, ~~the Children's Defense Fund~~, and Remove Intoxicated Drivers. (See Attachment 1 for a full listing of NATC ~~members.~~ supporters)

We urge Congress to raise excise taxes on alcoholic beverages. The Coalition specifically supports the doubling of current excise tax rates on hard liquor, and then equalizing beer and wine taxes at the liquor rate, according to alcohol content. These changes would provide an estimated $12 billion in new revenue.

Our nation is faced with staggering budget deficits that threaten our economic vitality. At the same time, Gramm-Rudman deficit reduction targets jeopardize the survival of important health care and social programs. This committee has an opportunity to address simultaneously the budgetary problems and social programs, and in so doing improve the economic and physical health of our nation.

-- Alcohol Tax Increases Are Long Overdue --

Federal excise taxes on beer and table wine were last increased in 1951, when Harry Truman was president. The tax on liquor rose 19 percent in October 1985, but still lags well behind the inflation that has occurred since the previous increase in 1951. The Consumer Price Index rose 335 percent between 1951 and 1987. Adjusted for inflation, beer and wine taxes are lower than they have ever been since the end of Prohibition, while the liquor tax is just slightly higher than the all-time low. (See Attachment 2.) Static taxes have allowed the real price of beer to fall 27 percent, of wine to fall 21 percent, and of hard liquor to fall 48 percent between 1951 and 1983. [1]

The failure of alcohol excise taxes to keep up with inflation has been a windfall for the alcoholic beverage industry -- but a disaster for the public health and for the Treasury. For the U.S. Treasury, it has meant the loss of about $80 to $100 billion in additional revenues between 1952 and the present. Now is the time for a major and long overdue overhaul of alcohol excise taxes.

-- The Public Supports Higher Alcohol Taxes --

Notwithstanding the public's general and understandable opposition to tax increases, there is remarkably broad support for raising excise taxes on alcoholic beverages.

Last year at a Senate Finance Committee Hearing, the

Treasury Department supported excise tax increases on the grounds that "the consumption of alcoholic beverages produces social costs not reflected in their market price."[2] We estimate that direct and indirect costs to the federal government plus tax expenditures related to alcohol problems amount to about $25 billion yearly.[3] Excise taxes on alcohol generated only $5.6 billion in FY '86.

Polls demonstrate that a large majority of the American public supports higher alcohol taxes.

* An August, 1984 Roper survey found that 77 percent of leadership persons surveyed (corporate executives, federal legislators, governors, religious leaders, educators, physicians, and the military command) approve of doubling the tax on alcoholic beverages to combat alcoholism.[4]

* A December, 1986 Gallup poll found that 66 percent of respondents supported doubling alcohol excise taxes to fight alcohol abuse.[5]

* A June 1987 Washington Post/ABC News poll found that 75 percent of respondents supported higher alcohol taxes.[6]

Furthermore, The New York Times, Los Angeles Times, and Washington Post have all editorialized in support of higher alcohol excise taxes. (See Attachment 3.)

Distinguished economists, including Martin Feldstein, Joseph A. Pechman, Henry J. Aaron, and Lester Thurow, have recognized the benefits that would flow from increasing alcohol taxes. In 1986 prominent economists, including 3 Nobel laureates, petitioned Congress to raise taxes on alcoholic beverages substantially, both to reduce budget deficits and improve the public health. These economists specifically called for equalizing the tax rates based on alcohol content. (See Attachment 4.)

-- Tax Beverages Equally on Basis of Alcohol Content --

We support equitable tax treatment for all types of alcoholic beverages. Currently, the alcohol in beer is taxed at about one-fourth the rate of liquor, and wine about one-seventeenth the rate. From both a public health and revenue perspective, these differentials make no sense.

In general, alcohol is alcohol is alcohol. In whatever form, it can be addictive and its abuse dangerous and life-threatening. Low taxes on beer and wine -- less than 3 cents on a 12-oz can of beer, and less than 3 cents on a bottle of wine -- perpetuate the dangerous myth that beer and wine are somehow innocuous "beverages of moderation." Liquor may be the most concentrated form of alcohol, but for teenagers, who are at high risk of auto accidents and other violent events, beer is the favored beverage. Beer is the choice of most drivers who end up in fatal auto accidents. Low-income alcoholics choose fortified wine, the cheapest source of alcohol, and suffer as a result. Alcohol, regardless of beverage type, should be taxed at the same rate.

-- Raising Excise Taxes Will Generate Up to $12 Billion/year --

The National Alcohol Tax Coalition urges Congress to double the liquor tax rate and then equalize beer and wine at the liquor rate. Such action would yield about $12 billion annually in additional revenue and reduce the costs related to alcohol abuse by about $16 billion. If beer and wine taxes were simply raised to the current liquor rate, net revenues would increase by approximately $4.7 billion and the costs related to alcohol abuse problems would be reduced by about $6 billion.

In addition to raising the tax rates, the rates should be indexed to inflation. Such a change would ensure that the relative price of alcoholic beverages in our economy remains stable, and would guarantee that the U.S. Treasury is never again robbed by inflation of billions of dollars in revenue. As the Treasury Department testified last year before the Senate Finance Committee, "the alternative of having fixed rates slowly eroded by inflation is on balance undesirable. We thus support the Chairman's proposal [to adjust tax rates for inflation]."[7]

-- Health and Social Benefits of Higher Alcohol Excise Taxes --

While the alcoholic beverage industry fears that higher taxes would reduce sales and profits, it is worth emphasizing that alcohol, like cigarettes, is different from virtually all other products on the market. According to the National Institute on Alcohol Abuse and Alcoholism, the yearly toll of alcohol abuse and alcoholism is between 100,000 and 200,000 lives lost and about $120 billion in economic harm. Statistics, however, don't begin to describe the widespread suffering that results from excessive drinking.

While the tragedies of drunk driving are well-known, alcohol is also related to half or more of all drownings, child and wife abuse, rapes and homicides. Alcohol affects practically every organ in the body and, in sufficient quantity, causes brain damage, liver cirrhosis, birth defects, heart disease, and cancers of the breast, liver, mouth, throat, esophagus, and larynx. The harm alcohol causes in the form of broken families, ruined careers, and school failure is incalculable. The dollar costs include health care costs, reduced productivity, and social welfare programs, among other factors. It is no wonder that alcohol abuse is considered by many experts to be the number one drug problem in America.

In 1981, the National Research Council conducted a major examination of policies which would prevent alcohol abuse and alcoholism. The Council's report, "Alcohol and Public Policy," strongly linked the price of alcohol to its abuse. The Council concluded that "alcohol consumption and the problems caused by it respond to the price of alcoholic beverages, and we infer that the large reductions in the real cost of alcohol to consumers in recent years as likely to have exacerbated drinking problems."[8]

Economists at the National Bureau of Economic Research have presented impressive evidence that increases in beer taxes would be extremely effective in reducing highway fatalities among teenagers and young adults. They estimate that raising the tax on beer to equal the tax on hard liquor would reduce accident deaths for 18 to 20 year-old males by 20 percent. Thousands of lives would be saved in the coming years. The 1987 Economic Report of the President to Congress said, "Higher alcohol taxes would also reduce fatalities. Studies of teen-age drunk driving indicate that if the real excise tax on beer were at its 1951 level, an estimated 1,000 fewer deaths per year would result, primarily of persons aged 18 to 21."[9]

Studies at Duke University have correlated increased taxes at the state level with reduced levels of alcohol-related problems. Economist Philip Cook examined the effects of 38 liquor tax increases in 30 states between 1961 and 1975. He found that increases correlated not only with decreased consumption, but also with decreases in cirrhosis of the liver and highway fatalities.[10] Notably, these findings indicate that alcohol consumption among heavy drinkers, those who suffer the most and cause the greatest harm related to alcohol, is affected by tax-induced price increases.

-- Alcohol Excise Taxes Are Not Particularly Regressive --

The alcoholic beverage industry has alleged that excise taxes are regressive -- that taxes on alcoholic beverages would hurt low-income consumers most. Although low-income consumers

pay a higher proportion of their disposable income for a particular product than would a wealthy person several factors distinguish taxes on alcoholic beverages from other excises, such as on gasoline or telephone service and minimize discriminatory effect on the poor.

First, alcoholic beverages are relative luxuries -- discretionary items -- not essentials like telephone service and transportation. Second, as the Treasury Department advised the Senate Finance Committee last year, "a principal justification for imposing a Federal excise tax on ... alcoholic beverages is that the consumption of alcoholic beverages produces social costs not reflected in their market price."[11] Third, higher taxes on alcohol would hardly be felt by about two-thirds of the adult population. Forty percent drink less than once a year or never, and another 29 percent drink less than 3 drinks per week.[12]

Among drinkers, upper-income households spend over twice as much on alcoholic beverages as lower-income households. Lower-income persons, about 25 percent of whom are elderly persons who consume the least alcohol of any adult cohort, spend only a small fraction -- around 3 percent -- of total expenditures on alcohol. This figure would rise only slightly under any of the scenarios the Committee is considering.

Industry marketing data on alcoholic beverages, compiled by the Simmons Market Research Bureau, and reported in Impact magazine (September 1, 1985), are instructive in determining the alleged regressive impact of increases in excise taxes on alcohol. For the highest category of household income ($50,000 and over), 49.4 percent report consumption of beer, 64.3 percent drink wine and 65.8 percent drink liquor. In contrast, only 30.2 percent of households with under $10,000 in income report drinking beer, 28.6 percent drink wine and 36.5 percent liquor. Even for households with income between $20,000 and $24,999, only 45.6 percent report drinking beer, 44.3 percent drink wine and 54.9 percent liquor. Therefore, increases in excise taxes on alcoholic beverages will be paid predominantly by those outside of the lowest income brackets. (See Attachment 5.)

Finally, according to the National Institute on Alcohol Abuse and Alcoholism, roughly 9.3 percent of drinkers consume 65 percent of all alcohol. Higher taxes -- and prices -- on alcoholic beverages would discourage excessive drinking among many in this relatively small fraction of all adults. Those who continued to drink heavily would be required to contribute more equitably to offset the costs of alcohol abuse to society.

The fact that organizations that care passionately about the plight of the poor, such as Children's Defense Fund and American Association of Retired Persons, are four-square in favor of raising alcohol excise taxes suggests that the alcoholic beverage industry's sudden compassion for poor people is nothing more than a thinly veiled defense of their own profits.

-- State Alcohol Taxes, Too, Have Increased Little --

The alcoholic beverage industry sometimes argues that while federal excise taxes have not increased in 36 years (or in the case of distilled spirits, increased little) consumers are paying much higher taxes because states have raised their rates. Many states have indeed raised their tax rates, but on the average, state taxes on alcoholic beverages have fallen way behind inflation: between 1965 and 1984 state tax rates, adjusted for inflation, decreased 58 percent for beer and 53 percent for liquor.

-- Conclusion: Raise Taxes Now --

In conclusion, the time has come for Congress to get in step

with the public and with sound economic policy. Thirty-six years of inaction on alcohol excise taxes must be remedied. Congress should double the liquor tax, adjust beer and wine taxes to the liquor rate, and stabilize these rates by mandating annual adjustments for inflation.

That concludes my statement. I would be pleased to answer any questions Members of this Committee might have.

Footnotes

1. "Economic Report of the President," January, 1987, pg. 187.
2. Statement of J. Roger Mentz, Department of the Treasury, before the Committee on Finance, U.S. Senate, April 21, 1986.
3. "Impact of Alcohol Excise Tax Increases on Federal Revenues, Alcohol Consumption, and Alcohol Problems," National Alcohol Tax Coalition, September 18, 1985, p.13, footnote 5.
4. Roper Survey, August, 1984, sponsored by Christopher D. Smithers Foundation.
5. "Public Backs Strong Measures to Fight Alcohol, Drug Abuse," The Gallup Poll, December 18, 1986.
6. Washington Post/ABC News poll conducted 6/25/87-6/29/87 as reported in the Washington Post, July 2, 1987.
7. See Note 2.
8. "Alcohol and Public Policy: Beyond the Shadow of Prohibition," National Research Council, 1981, p. 71.
9. "Economic Report of the President," January, 1987, p. 188.
10. Cook, Philip J., "Liquor Taxes and Drinking, Cirrhosis, and Auto Accidents in "Alcohol and Public Policy: Beyond the Shadow of Prohibition, 1981.
11. See Note 2.
12. All figures in this section are from, "Alcohol Excise Tax Facts: Who Pays, and How Much?" National Alcohol Tax Coalition, May 1987.

Attachment 1

NATIONAL ALCOHOL TAX COALITION
NATIONAL SUPPORTERS

Adventist Health Network
Alcohol Policy Initiatives Project, Trauma Foundation
American Association of Retired Persons
American College of Preventive Medicine
American Council for Drug Education
American Council on Alcohol Problems, Inc.
American Licensed Practical Nurses Association
American Medical Students Association
American Nurses Association
American Youth Work Center
Association of Junior Leagues
Association of Schools of Public Health
Center for Science in the Public Interest
Child Welfare League of America
Children's Defense Fund
The Children's Foundation
Citizens for Highway Safety
Consumer Affairs Committee of Americans for Democratic Action
Doctors Ought to Care
National Association for Public Health Policy - Council on Alcohol Policy
National Association of Children's Hospitals & Related Institutions
National Association of Private Psychiatric Hospitals
National Association of State Alcohol and Drug Abuse Directors
National Center for Drunk Driving Control
National Council on Alcoholism
National Council on the Aging, Inc.
National Drivers Association for the Prevention of Traffic Accidents, Inc.
National Women's Christian Temperance Union
National Women's Health Network
Public Citizen
Remove Intoxicated Drivers

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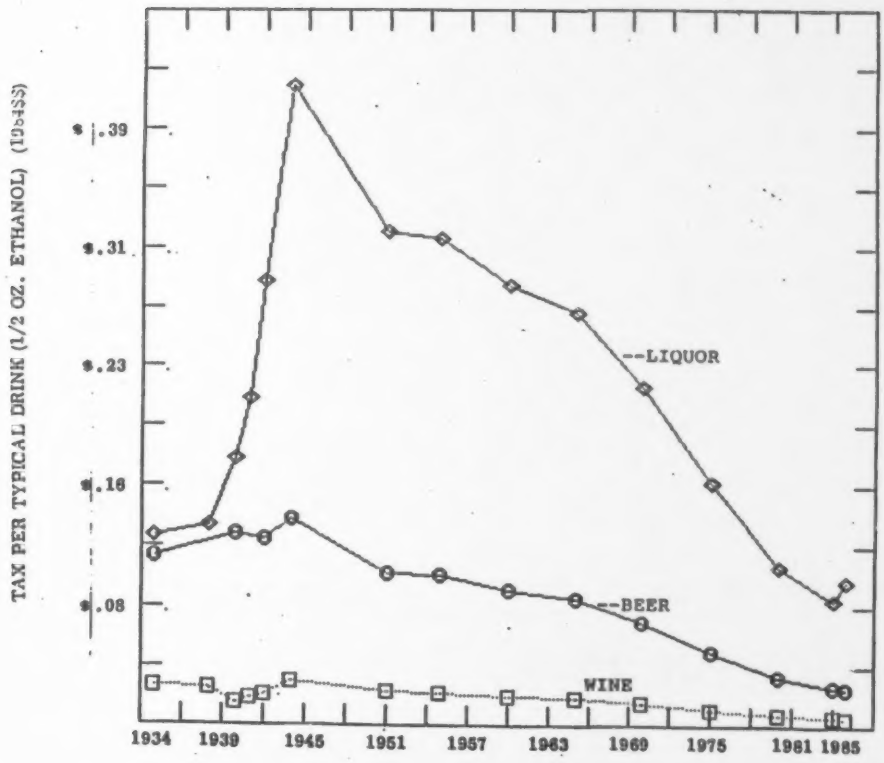
Attachment 2



RELATIVE TAXES ON BEER, WINE LIQUOR (1934 - 1985)

Attachment 3

The Washington Post SATURDAY, SEPTEMBER 27, 1986

Higher Taxes on Beer and Wine

THE WAR on illegal drugs that Congress and the administration are bent on prosecuting is going to be expensive. The bill already passed by the House carries a price tag of $3 billion. While the final legislation may be a bit more modest, proponents are calling for more law enforcement, more education programs, more treatment facilities and more aid to local governments. So far, no one in this era of Gramm-Rudman has said where the money is supposed to come from. There's not much chance the income tax is going to be increased, and the nondefense budget can't be trimmed much further.

There is one source of revenue, though, that hasn't been given sufficient attention. Appropriately, it is related to substance abuse. Any levy that will put almost $5 billion a year into the Treasury will make it easier to fund an ambitious new narcotics control effort. This could be accomplished simply by changing the formula for the federal excise tax on beer and wine.

A six-pack of beer now costs about the same as a six-pack of Coke. Alcohol in this form is cheap, which surely boosts the popularity of beer among teen-agers. The tax on wine is also low, and sales of wine coolers to young people are on the rise. But these taxes do not reflect the *alcohol content* of the drink. A can of beer, a glass of wine and a shot of liquor contain equal amounts of alcohol—a fact that many teen-agers don't recognize. Yet the federal taxes on each are, respectively, 2.7 cents, 0.5 cents and 10 cents. Why should there be such a disparity? The tax on distilled spirits has been raised in recent years—it went up only last October—while the tax on wine and beer has remained unchanged since 1951.

Thirty-six percent of adult Americans don't drink alcoholic beverages of any kind. Another third of this population has three or fewer drinks a week and for them an increase in the excise tax would hardly be noticed. Of the final third, some might drink less to compensate for the increased cost. If most chose to continue to consume beer and wine at the same rate in spite of higher taxes, the Treasury would be the beneficiary. Revenues would be substantial. Why aren't more people on the Hill talking about this idea seriously?

Los Angeles Times Part II/Friday, March 27, 1987 *

Paying the Piper

It is time that Americans stop allowing themselves to be seduced by the notion they can have all the governmental goodies that they want without paying for them. While President Reagan denounced Congress all these years for being hooked on the idea of tax and spend, his Administration has engaged in a wholesale program of borrow and spend. As late as Wednesday he went to the Capitol and tried to apply his just-say-no drug message to taxes.

But time, and the horrendous federal debt, has rendered that message obsolete if not downright dangerous. After trillion-dollar defense increases and trillion-dollar tax reductions, the piper must be paid. A modest, even timid, down payment is the roughly $18-billion tax increase proposed by Democratic budget-makers in Congress.

Recent polls suggest that Americans are prepared to accept higher taxes to pay for expanded social programs. The Democrats' budget outline would not in fact prevent additional cuts in domestic spending. It would not even prevent the nation from going further into debt. But at least it would help brake the slide into an abyss of red ink.

The obvious place to start is with an overdue increase in excise taxes on alcoholic beverages, tobacco and gasoline. The $18.5 billion could be raised this way: doubling the cigarette tax from 16 cents a pack to 32 cents; doubling the federal gasoline tax from 9 cents to 18 cents; increasing the tax on distilled alcohol from $12.50 a gallon to $15 a gallon, and making the beer and wine tax comparable to that on distilled spirits.

None of these increases would work a severe hardship on the public. Each might have a beneficial social effect by modestly discouraging excessive smoking and drinking and encouraging gasoline conservation. They would produce no real drag on economic growth.

The beer and wine tax has not been raised since 1951. The tobacco tax is only about 15% of the market price of cigarettes, compared with 42% in 1951. As for gasoline, the U.S. tax levy on motor fuel is one of the lowest in the world, with many other countries charging as much as $1 a gallon. The special interests involved, particularly beer and wine and tobacco, have used their lobbying muscle to get a free ride for years. Excise taxes amount to less than 4% of the gross national product, compared with almost 9% in 1971.

An argument can be made that raising these taxes is good public policy even absent the budget deficit. Given the magnitude of the debt today, an increase is essential.

THE NEW YORK TIMES, WEDNESDAY, APRIL 30, 1986

The New York Times

Yes, Raise the Alcohol Tax

A large group of leading economists proposes to raise $12 billion annually for the Federal Treasury by sharply increasing taxes on alcohol, which have not kept pace with inflation. Although sales taxes generally are not the best approach to budget balancing, reverting to higher taxes on alcohol seems a good way to help reduce the deficit.

Congress raised the excise tax on a fifth of 80-proof liquor last year from $1.67 to $2. But that increase, the first since 1951, still left the tax lower, in constant dollars, than it was at the repeal of Prohibition a half-century ago. The increase also widened the gap between taxes on hard liquor and those on beer and wine; beer is now taxed at one-fourth the liquor rate, wine at one-seventeenth.

The economists' group proposes doubling the tax on hard liquor to $4 a fifth, which would bring the tax rate, when adjusted for inflation, back only to the levels of 1972. Beer and wine would be taxed at the same rate as liquor, in proportion to alcohol content. That would add about $1.50 to the standard bottle of wine and six-pack of beer.

Such levels of taxation might discourage consumption of alcohol and raise less than the predicted $12 billion in revenue. But the Government and economy would presumably still benefit from gains in productivity and lower health-care costs, both of which are heavily affected by alcohol consumption. Increasing alcohol taxes is a sound way to either raise or save money.

Attachment 4

ECONOMISTS' PETITION TO INCREASE FEDERAL ALCOHOL EXCISE TAXES

We, the undersigned economists, believe that the public health costs and other external costs associated with the consumption of alcoholic beverages are so significant as to justify substantial excise taxes on those beverages. In light of the fact that, in real terms, existing taxes have declined dramatically in the past thirty years and those on wine and beer were not increased even in nominal terms between 1951 and 1985, existing tax rates should be increased.

Further, we see no justification for the differential between the excise tax, per unit of alcoholic content, on beer and wine, on the one hand, and hard liquor on the other. Indeed, in light of the fact that beer is the standard introduction to alcohol for youth, favored tax treatment for it appears to be socially highly undesirable.

Finally, an increase in the excise tax on alcoholic beverages would contribute to the reduction in the budget deficit in a way that has no significant adverse economic effects and would have substantial social benefits, while tending to increase economic efficiency.

Consequently, we support efforts by the NATIONAL ALCOHOL TAX COALITION to increase federal excise taxes on alcoholic beverages and eliminate or modify the differential tax treatment between beer, wine, and liquor.

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11/86

Attachment 5

UPPER INCOME HOUSEHOLDS PAY THE BULK OF ALCOHOL EXCISE TAXES

For liquor and wine, over half the excise taxes are paid by the 38 percent of the households that have income in excess of $30,000. For beer, this same group pays just under half of federal excise taxes. Low-income households (<$10,000 income), who represent 20 percent of the population, pay 11.9 percent of beer taxes, 10.3 percent of wine taxes, and 10.7 percent of taxes on liquor.

Household Income	$5000	$5000–$9999	$10,000–$19,999	$20,000–$29,999	$30,000 +	Total
Percentage of Households *	7.66%	12.43%	22.40%	19.08%	38.3%	99.87%
Percentage of Excise Taxes Paid: **						
Beer	4.5%	7.4%	19.8%	19.7%	48.7%	100.1%
Wine	4.0%	6.3%	17.3%	17.8%	54.7%	100.1%
Liquor	4.0%	6.7%	18.0%	18.7%	52.6%	100%

Sources:

*U.S. Census Bureau (1985 population figures).
**"The Distributional Effects of an Increase in Selected Federal Excise Taxes," The Congressional Budget Office, January 1987, Table 3.

IMPACT OF ALCOHOL EXCISE TAX INCREASES ON FEDERAL REVENUES, ALCOHOL CONSUMPTION, AND ALCOHOL PROBLEMS

by

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September 18, 1985

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SUMMARY

Federal excise taxes on alcoholic beverages have not been increased since 1951. Consequently, the taxes (adjusted for inflation) are lower than they have ever been since the end of Prohibition. The low tax rates have contributed to declining relative prices, and hence increased consumption ... and increased alcohol problems. Had excise taxes been adjusted regularly for inflation, the federal government would have received several tens of billions of additional tax dollars between 1952 and 1984.

Raising excise taxes would reduce both budget deficits and alcohol problems. Tax increases would likely have an especially great effect on reducing alcohol consumption by youths.

A model was developed to estimate the effects of various tax increases. Of the five different plans considered, a doubling of the excise tax, which would still not bring the taxes up to pre-inflation levels, was found to have the least effect on revenues, sales, and problems: $4.3 billion in new revenue per year and a 5.2 percent decline in alcohol consumption. The reduced drinking would reduce alcohol problems by about $6 billion annually. The greatest impact would come from raising the tax on liquor to make up for inflation since 1951 and then raising the relatively low taxes on beer and wine to equal the rate per unit of alcohol in hard liquor. This adjustment would yield $20.5 billion in net revenue and result in a 30.2 percent decrease in consumption and a decrease in alcohol problems estimated to save about $36 billion.

After considering historical tax rates and the effects of tax increases, several recommendations are made. First, the tax on hard liquor should be doubled, returning it to its 1972 level (adjusting for inflation). Then the taxes on beer and wine should be raised so that these beverages are taxed at the same rate per unit of alcohol as liquor. To prevent these taxes -- and prices -- from being eroded by future inflation, alcohol taxes should be adjusted annually to keep pace with disposable income and inflation. These adjustments would generate approximately $12 billion annually in new revenues and reduce alcohol consumption by 14 percent. The decline in drinking would reduce direct and indirect costs of alcohol problems by about $16.4 billion. Using different assumptions about the relative elasticity of demand for alcoholic beverages, the increased tax revenues would vary between $8.4 billion and $13.7 billion; decline in consumption, 3.2 to 32 percent; reduction in alcohol problems, $4 billion to $38 billion. Finally, portions of the revenue should be earmarked for alcohol education and treatment programs, training programs for dislocated workers, and aid to states.

I. Introduction

Alcoholic beverages are among a small group of products on which special federal excise taxes are levied. Though the taxes are sometimes derided as old-fashioned "sin taxes," there are good reasons why this group of beverages (along with cigarettes) has been singled out for what might also be called "health taxes." Alcohol is a factor in 100,000 to 200,000 deaths each year, according to the National Institute on Alcohol Abuse and Alcoholism (NIAAA).[1]

While the tragedies of drunk driving are well-known, alcohol is also related to half or more of all drownings, child and wife abuse, rapes, and homicides. Alcohol affects practically every organ in the body and, in sufficient quantity, causes brain damage, liver cirrhosis, birth defects, heart disease, and cancers of the liver, mouth, throat, esophagus, and larynx. The harm alcohol causes in the form of broken families, ruined careers, and school failure is incalculable. According to studies sponsored by the congressional Office of Technology Assessment and the Alcohol, Drug Abuse, and Mental Health Administration (ADAMHA), alcohol problems result in direct and indirect costs to society of $120 billion annually.[2] These dollar costs include health care costs, reduced productivity, and social welfare programs, among other factors. It is no wonder that alcohol is considered by many experts to be the number one drug problem in America.[3] Levying special taxes on alcoholic beverages needs to be considered in the context of these societal costs.

While alcohol problems saddle individuals, families, and employers with huge costs, they also engender substantial costs to the federal government. These costs include (a) direct expenses for treatment of sickness and injuries through Medicare [4], Medicaid, Indian Health Service, Department of Defense, and health insurance premiums for federal employees, as well as the entire budget of NIAAA; (b) loss of productivity among federal employees, due to sickness and death related to alcohol; (c) reduced income tax revenue due to reduced productivity in the private sector. No comprehensive study of these direct and indirect costs has been conducted, but it would appear that they total upwards of twenty billion dollars a year.[5] One can look upon excise taxes as partial reimbursement to the government for these various costs of alcohol problems.

During much of America's recent history, excise taxes on alcoholic beverages provided a substantial percentage of federal revenues: over 11 percent in 1941 and 5 percent in 1951.[6] In stark contrast, the $5.4 billion in alcohol excise taxes collected in 1984 provided only 0.8 percent of total federal revenues.[7]

Federal excise tax rates imposed since 1934 are listed in Table 1. While tax rates remained constant between 1951 and 1984, inflation greatly reduced the value of the tax dollars. As shown in Table 2 and the Figure (see next page), taxes (expressed in 1984 dollars) on all three types of alcoholic beverages -- beer, table wine, and liquor -- are lower, in real terms, than at any time since the repeal of Prohibition. At the height of World War II, taxes, in terms of purchasing power, were about five times higher than at present.

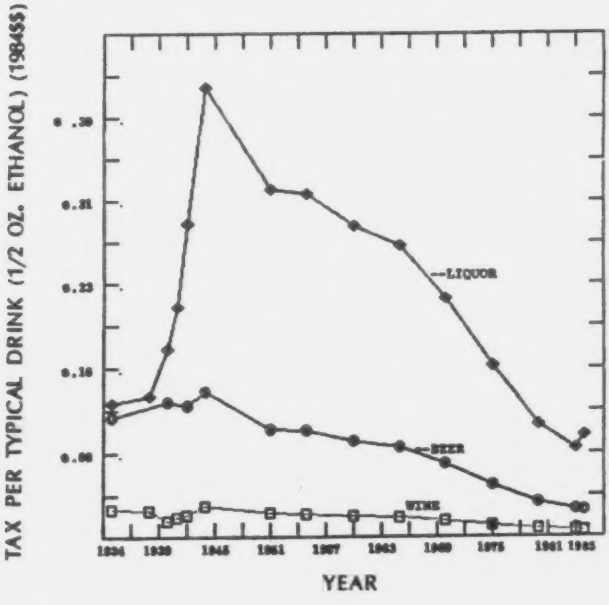
After the modest 1951 tax increases (12-16 percent) that helped finance the Korean War effort, rates remained constant for several decades, while inflation gradually shrank the value of the dollar by about seventy-five percent. In fact, if excise taxes had been linked to inflation, the federal government would have garnered an additional $105 billion between 1952 and 1984 (1984 dollars), assuming sales had remained constant, or perhaps $40 billion to $75 billion if sales declined because of increases in absolute prices.[8]

Table 1 Federal Excise Taxes on Alcoholic Beverages (actual dollars)

DATE	BEER (gallon)	WINE (gallon)	LIQUOR (gallon - 100 proof)
Jan., 1934	$.16	$.10	$ 2.00
July 1, 1938		.10	2.25
July 1, 1940	.19	.06	3.00
Oct. 1, 1941		.08	4.00
Nov. 1, 1942	.23	.10	6.00
Apr. 1. 1944	.26	.15	9.00
Nov. 1, 1951	.29	.17	10.50
July 1, 1984	.29	.17	10.50
Oct. 1, 1985	.29	.17	12.50

Table 2 Federal Excise Taxes (expressed in 1984 dollars)

DATE	BEER (gallon)	WINE (gallon)	LIQUOR (gallon - 100 proof)
Jan., 1934	$1.27	$.79	$15.71
July 1, 1938		.74	16.55
July 1, 1940	1.43	.44	22.22
Oct. 1, 1941		.54	27.17
Nov. 1, 1942	1.40	.62	37.18
April 1, 1944	1.54	.89	53.54
Nov. 1, 1951	1.14	.67	41.35
July 1, 1984	.29	.17	10.50
Oct. 1, 1985	.28	.16	11.97



TAXES ON BEER, WINE, LIQUOR (1934 - 1985)

FIGURE

In 1984, with budget deficits soaring to records highs, Congress turned once again to alcohol taxes as a source of revenue. Congress raised the tax on hard liquor by 19 percent (as of October 1, 1985), but left untouched the taxes on beer and wine.[9] With huge deficits straining the U.S. economy, and putting tremendous pressures on social programs for the poor, the possibility of additional alcohol tax hikes remains a viable -- and increasingly inviting -- political option.

Increasing the excise taxes on alcohol does more than raise revenue. Because higher taxes mean higher prices, they also lead to reduced drinking.

Scholars have studied the relationship between taxation and prevalence of alcohol problems. For example, Philip Cook, professor of public policy studies and economics at Duke University, has shown a correlation between state liquor tax increases and reductions in the rates of liver cirrhosis and auto fatalities.[10] Thus, while the reduced consumption of alcohol partially offsets the revenue-enhancing effect of tax increases, it can provide major health and social benefits to society.

The government of Sweden has mounted a multi-faceted effort to reduce that nation's drinking problems. According to the Swedish government, "The taxation of alcoholic beverages has long been of great importance for the national budget, and it has also served as perhaps the most powerful instrument of a temperance policy designed to keep consumption within reasonable limits."[11] Similarly, the U.S. NIAAA reports that:

> Lowering the alcohol consumption levels is associated with reduction in a number of adverse effects of drinking such as alcohol-related traffic accidents (especially by youth) and diseases such as cirrhosis of the liver. Some effective efforts, documented through research, are increasing taxes on alcoholic beverages....[12]

The practical effect of current policy -- keeping excise taxes stable -- is that true alcoholic beverage prices tend to rise more slowly than inflation, thereby contributing to increased consumption. According to Cook:

> Between 1967 and 1983 the real price of alcoholic beverages, adjusted for overall inflation, declined 27 percent. Distilled spirits have led the way with a 48 percent decline in average price, followed by beer with a 25 percent fall and wine with a 19 percent reduction.[10]

Those "real price" declines have made alcoholic beverages ever more competitive with soft drinks and other beverages for the consumer's dollar. As Mosher and Beauchamp have pointed out,

> [S]ince 1970 ... a $5.00 purchase of an alcoholic beverage increased to $10.83 in 1983, while a $5.00 purchase of a nonalcoholic beverage increased on the average to $21.56 during the same period.[13]

The static excise tax component was a significant, but not sole, factor in moderating the price rises for alcoholic beverages.

The comparatively lower prices of alcoholic beverages are particularly important in the purchasing decisions of youths, who are responsible for a disproportionate number of fatal and non-fatal automobile accidents. Michael Grossman and Douglas Coate of the National Bureau of Economic Research and Gregory Arluck of the New York Telephone Company, have written:

> The reduction in real alcoholic beverage prices since 1960 or 1976 due to the stability of excise tax rates is inconsistent with the goals of discouraging alcohol abuse and reducing motor vehicle accidents and deaths. Indeed, government policies actually may be making these problems worse.[14]

One argument made against increasing excise taxes is that such taxes, like sales taxes, are regressive, affecting low-income people more than middle- and upper-income people. For several reasons, we cannot give much credence to this concern. According to a 1977 U.S. Department of Agriculture survey, households earning under $10,000 per year spent less than 90 cents per week on alcoholic beverages, while households with incomes over $20,000 spent $2.82 per week.[15] For the one-tenth of the population with the lowest incomes, expenditures for alcohol represent only about 0.2 percent of total income.[15] Also, alcoholic beverages can hardly be considered necessities and therefore worthy of exemption from taxation. Excise taxes penalize not poor people, but all drinkers, who are taxed, fairly, in direct proportion to the amount they drink and, on the average, to the amount of damage they cause to their families and society. For light drinkers, who constitute one-third of the population and consume little more than one drink per week, the cost of even a major tax increase would be only a few dollars a year, while non-drinkers -- 36 percent of adults -- would pay nothing at all. Finally, the fact that Children's Defense Fund, Children's Foundation, the American Association of Retired Persons and other organizations concerned about low-income people support increased excise taxes further indicates that regressivity is not a paramount consideration in this matter.

A second argument against raising federal excise taxes is that, because of reduced sales of alcoholic beverages, states would receive less revenue from their own taxes. This is true, but could be remedied easily by either compensatory increases in state taxes or by revenue sharing. A national increase has a substantial advantage over helter-skelter increases in state taxes: consumers are not given an incentive to drive across borders to buy lower cost products, as happens when a state raises its taxes higher than bordering states.

***

Revenue-seeking legislators and prevention-oriented alcohol experts have proposed various forms of tax increases:

1. Raise taxes to correct the diluting effect of inflation since 1951. A 1951 dollar was worth only 25.4 cents in 1984. Therefore, adjusting for inflation would roughly quadruple the current tax (292 percent increase).

2. Raise beer and wine tax rates to equal (on a per unit alcohol basis) the rate at which liquor is taxed. Equalizing the taxes would quadruple the tax on beer and increase by seventeen-fold the tax on wine.

3. Double all the alcohol taxes.

4. Some combination of these, such as correcting for inflation and equalizing the rates.

In projecting the overall impact of various tax increase possibilities, several factors must be considered, including:

(a) to what extent will tax increases affect prices?

(b) to what extent will the higher prices reduce sales?

(c) to what extent will reduced sales reduce the level of alcohol abuse and alcoholism?

After considering each of these questions, we will present our projections of the effect of tax increases on tax revenues, alcohol consumption, and alcohol problems, followed by our recommendations.

II. Estimates of Key Variables

(a) To what extent will tax increases affect prices?

There is little agreement on how tax measures would affect beverage prices. One could assume, naively, that prices would be increased by an amount equal to the tax increase. That is, a $1 per gallon tax increase on liquor would increase the price by $1. Industry observers, however, note that wholesalers and retailers apply a standard mark-up to the prices they are charged by suppliers, not distinguishing between the base price and taxes. They also suggest that companies may try to maintain profits, in the face of higher prices and lower consumption, by raising prices more than the actual value of the tax. Beverage Management Resource Group (BMRG) predicts mark-ups on the tax increase of 58 percent for liquor, 100 percent for table wine, and 81 percent for beer.[16] (Apparently, BMRG believes that the smaller the tax increase, the easier it would be to pass it through to the consumer with a full mark-up; liquor is taxed more heavily than beer which is taxed more heavily than wine.) That is, a $1.00 increase in the tax on a bottle of liquor would lead to a $1.58 increase in the price.

Others suggest that since the tax does not represent a "real" production or distribution cost, it could be passed on without any mark-up at all. Also, competition would serve to minimize, or at least moderate, the mark-up. Cook estimates a mark-up on liquor of only 18-20 percent [17] while Jeffrey Harris of M.I.T. assumes no mark-up.[10] The Department of Treasury's Office of Tax Analysis has estimated a straight pass-through of the tax increase plus interest costs to finance the higher prices of merchandise.[18]

We will assume that distributors and retailers will pass the entire tax, plus a 20 percent mark-up, on to consumers. (Appendix II includes projections based on 0 percent and 40 percent mark-ups.)

(b) To what extent will the higher price reduce sales?

Grossman et al. state, "although alcohol use is a behavior that has habitual elements, there is no evidence that this behavior is insensitive to price."[14] All parties agree that

price increases will reduce alcoholic beverage sales. A significant number of individuals will drink less frequently; switch to lower-proof liquor, soft drinks, and other non-alcoholic beverages; and drink less on each drinking occasion. But some consumers will "evade" the price hikes by buying less expensive brands of their favorite drinks, but drinking as much as ever. And, if alcoholic beverage prices rise sharply, industry spokesmen have said, bootleg beverages might replace a small fraction of the legally produced products. Actual consumer behavior is impossible to predict with accuracy, but one can be confident that sales will not increase.

Grossman et al. developed a mathematical model to estimate the effect of price increases on drinking by 16-21 year olds. They conclude that modest price increases -- 30 cents (5.6%) for a bottle of liquor and 10 cents (7%) for a six-pack of beer -- would decrease drinking among young people as much as raising the drinking age by 1 year.[14]

The Swedish government has instituted various measures, including advertising bans, drunk driving laws, and higher taxes, to reduce abusive drinking. The Swedes have concluded that higher excise taxes have been the key factor in reducing per capita consumption of alcohol by 21 percent between 1976 and 1983.[19]

The effect of price on consumption is referred to as "price elasticity." An elasticity of -1.0 means that for every 10 percent increase in price, consumption would decline by 10 percent. Several estimates of alcoholic beverage price elasticities are shown in Table 3.

Table 3. Price Elasticities of Alcoholic Beverages

AGENCY/INDIVIDUAL	PRICE ELASTICITY
Distilled Spirits Council of the U.S.[20]	-0.5 (liquor)
OMB/Dept. of Treasury [21]	-0.79 (liquor) -0.3 to -0.4 (beer/wine)
Philip Cook [10]	-1 (liquor)

In a wide-ranging review of the literature, Stanley Ornstein, of the Graduate School of Management, University of California at Los Angeles, concluded that the consensus of reliable studies indicated an elasticity of -0.3 to -0.4 for beer, but that there was no consensus for liquor and wine.[22] The very divergent estimates of elasticities coming out of various, relatively reliable studies (beer, -0.33 to -0.89; wine, -0.44 to - 1.59; liquor, -1.0 to -2.0) indicates the difficulty of predicting accurately the extent to which increased prices would affect sales. These estimates were generally developed from studies of the effects of relatively small state tax increases or by less quantitative means. (The price elasticity of cigarettes falls in the same general range as that estimated for alcoholic beverages.[23])

We are dubious of the very high estimates of price elasticities, because drinking is a deeply ingrained habit and many millions of Americans are addicted to alcohol. Also, we believe price increases would spur many people to switch to less expensive brands. Consequently, we will base projections on an elasticity for all three categories of beverages of -0.35 (i.e., a 10 percent rise in prices will be projected to cause a 3.5 percent drop in sales). (Appendix II includes projections based on elasticities of -0.1 and -0.7.) The choice of price elasticity has a marked effect on estimates of tax revenues and sales.

(c) To what extent will reduced sales reduce the level of alcohol abuse and alcoholism?

Predictions of the effect of reduced consumption on alcohol problems span a wide range. Opponents of tax increases argue that higher prices would discourage buying only by moderate alcohol consumers, while alcoholics and other heavy drinkers would maintain their consumption. Others argue that wealthy people -- heavy drinker or not -- would maintain their level of consumption, while low-income people and youths would decrease their consumption. Yet others maintain that the most straightforward assumption is that alcohol problems would decrease in rough proportion to the declines in consumption.

The argument that addicted drinkers account for the great majority of alcohol-related problems in our society has questionable validity. A National Academy of Sciences panel found that light and moderate drinkers appear to account for about half of all damage related to alcohol.[24] The relatively low frequency of problems that these people cause is made up for by the vast number of people in this group -- ninety percent of all drinkers.

Of course, to the extent that heavy drinkers reduce their drinking, alcohol problems will also decline. Grossman et al. found that the effects of price increases "are not limited to light or infrequent drinkers."[14] Robin Room, of the Alcohol Research Group of the Medical Research Institute of San Francisco, has concluded that "price measures ... appear to affect the heaviest drinkers as much as or more than others, and often result in at least short-term reductions in cirrhosis mortality and other chronic health problems, alcohol-related casualties, and social disruption."[25] In an editorial supporting a ban on alcohol advertising, the editors of Lancet, the British medical journal, wrote:

> The general view is that a fall in per capita consumption is reflected in a greater fall of consumption by heavy drinkers, who of course are those at greatest risk of alcohol-related harm.[26]

Grossman et al. have highlighted the long-term beneficial impact on alcohol problems that would flow from decreased youth drinking:

> Since alcohol abuse in adolescence appears to be associated with alcohol abuse in adult life, policies to prevent the onset of this behavior by adolescents might be the most effective means to reduce it in all segments of the population.[14]

In Sweden, the decline in per capita consumption of alcohol was paralleled by a decline in abusive drinking by youths. Heavy drinking (half a bottle of liquor, or more, at a time) among 16-year old boys also declined significantly (from 40% of boys in the 1970s to 28% in 1981).[27]

Cook and Tauchen have found that increasing the federal liquor tax by 16 cents on a fifth of 80 proof spirits would reduce the rate of cirrhosis mortality by 1.9 percent. Extrapolating from that finding, the authors estimate that doubling the federal liquor tax would reduce the mortality rate by about 20 percent. Jeffrey Harris says that this would "mean a postponement of 6,000 deaths annually."[28]

Predicting the effect that reduced drinking would have on costs to society is impossible to do with any precision, because of a paucity of data. Different costs -- time lost from work, automobile accidents, cirrhosis, spouse abuse, etc. -- would each be affected to different extents, depending on drinking patterns and population sub-groups. For the present purposes, we will assume that alcohol problems will decrease in direct proportion to decreases in alcohol consumption.

III. Results

A model was developed to predict the effects of tax increases on alcohol consumption, tax revenue, and costs to society. (See Appendix I for details.)

The current excise taxes and the taxes that would be levied under five different scenarios for increases are listed in Table 4. Note that the different beverages would be little affected by some proposals, while heavily affected by others. Adjusting for both alcohol content and inflation would result in the greatest increases. Doubling the taxes would have little effect on beer and wine prices and consumption, but a sizable effect on liquor. For the sake of simplicity, only table wine is shown in Tables 4-6; fortified wine is now taxed at $.67 per gallon and naturally carbonated wine at $3.40 per gallon. The latter is currently taxed at a higher rate per unit of alcohol than hard liquor.

Table 5 translates the hypothetical tax rate increases into tax increases for typical products.

The projected effects of tax increases on tax revenues, changes in consumption, and reductions in alcohol problems are indicated in Table 6. (See also Appendix II for calculations based on several different assumptions of price elasticity and mark-ups on taxes.) Note that doubling the current taxes would have the least impact, while adjusting for inflation and taxing all beverages at the liquor rate would have the greatest impact on revenues and consumption. One effect of increasing excise taxes is that consumers would have less money available to purchase other goods and services. Thus, with other companies reporting lower gross sales, their income taxes would be commensurately lower. The Congressional Budget Office considers the average marginal tax rate to be 25 percent.[5c] The "loss of other taxes" in Table 6 reflects this consideration. "Net revenue increase" represents the new income to the federal treasury as a result of raising excise taxes.

IV. Conclusions and Recommendations

Alcohol excise taxes, expressed in constant dollars, are at a 51-year low. If our rising standard of living (inflation adjusted per capita disposable income) were factored in, the current taxes would appear even lower. America's alcohol tax policy has had several clear results: (a) alcohol prices, corrected for inflation, have been declining; (b) this has contributed to increased consumption of alcoholic beverages; (c) the higher consumption has led to increased alcohol problems and increased tax revenues; (d) inflation has reduced by three-fourths the value of the revenue brought in by the taxes.

Politicians, governmental advisory boards, and citizens' organizations are seriously debating whether alcohol (and tobacco) excise taxes should now be increased. After considering historical tax rates, the magnitude of alcohol problems in the U.S., and the impact of higher taxes on alcohol problems and net revenues, we conclude that the net

Table 4 - Tax Rates on Beer, Wine, and Liquor

Tax scenario	Beer (per gal.)	Wine (per gal.)	Liquor (per proof gallon)#
(a) Current rate	$0.29	$0.17	$12.50*
(b) Double current rate	0.58	0.34	25.00
(c) Adjust current rate for inflation	1.14	0.67	49.00
(d) Adjust current rate to equalize for alcohol content	1.13	2.90	12.50
(e) Double + equalize for alcohol	2.25	5.80	25.00
(f) Equalize for alcohol content + adjust for inflation	4.21	11.37	49.00

'Proof gallon' is one gallon of 100 proof liquor (50% alcohol).
* Liquor tax, now $10.50 per proof gallon, will increase to $12.50 on October 1, 1985.

Table 5 - Tax Increases Per Unit of Sale: Beer, Wine, Liquor*

Tax Change	Beer six-pack	Wine 1/5 Gal.	80 Proof Liquor 1/5 Gallon
(a) No new increase (other than planned liquor tax increase)	-	-	$.32
(b) Double current rate	$.16	$.03	2.32
(c) Adjust for inflation (x3.92)	.48	.10	6.16
(d) Equalize for alcohol content	.47	.55	.32
(e) Double + equalize for alcohol	1.10	1.13	2.32
(f) Equalize for alcohol content + adjust for inflation	2.21	2.24	6.16

* Tax increases applied at the manufacturing level; mark-ups may be applied as products pass through the distribution chain.

Table 6 -- Projected Effects of Tax Increases*

Tax Change	Increase in Excise Revenues (billions)	Loss of other taxes (billions)	NET REVENUE INCREASE	Change in Consumption	Change in Costs related to problems (billions)
(a) No new increase	$ .61	$ .14	$ .46	- 0.6%	-$ 0.7
(b) Double tax rates	$ 5.7	$1.4	$4.3	- 5.2%	-$6.3
(c) Adjust for inflation	$12.7	$3.2	$9.5	-14.2%	-$17.1
(d) Equalize at liquor rate	$ 6.24	$1.56	$4.7	- 4.8%	-$ 5.8
(e) Double taxes + equalize for alcohol	$15.7	$3.9	$11.8	-13.7%	-$16.4
(f) Adjust for inflation + equalize at liquor rate	$27.3	$6.8	$20.5	-30.2%	-$36.2

* In comparison to fiscal year 1984.

benefit to society of increases greatly outweighs any costs. Such increases appear to have popular support, according to a 1981 poll by Associated Press: 55 percent of respondents supported higher alcohol taxes, while 41 percent opposed them.

Doing anything about taxes -- or leaving them at current rates -- incurs trade-offs regarding revenues, alcohol consumption, jobs, alcohol abuse, and dollars spent on products other than alcoholic beverages. Two overriding considerations in this political equation are seemingly perpetual $200 billion a year federal budget deficits and the high rates of alcohol problems. Substantial excise tax increases would help alleviate both problems. While there would be costs in terms of higher prices and loss of jobs in the alcohol and related industries, these would be offset at least in part by higher tax revenues, reduced alcohol problems and associated costs to society, higher worker productivity, and some new jobs in other sectors of the economy.

As the first step in updating federal alcohol excise taxes, we recommend that the tax on distilled spirits, now set to be $12.50 per proof gallon beginning October 1, 1985, be doubled to $25 per proof gallon. The tax (in constant dollars) was at this rate or substantially higher between 1940 and 1972.

Our second recommendation is to tax all beverages equally on the basis of their alcohol content. Currently, liquor is taxed relatively heavily, table wine very lightly, and beer somewhere in between, probably reflecting traditional attitudes about spirits ("demon rum"). In reality, a can of beer, a glass of wine, and a small mixed drink all contain roughly the same amount of ethanol and pose roughly similar risks. There are beer alcoholics, wine alcoholics, and liquor alcoholics. The only justification for taxing hard liquor extra heavily is that, drunk straight, it is much more concentrated than beer or wine and can lead to faster inebriation. On the other hand, beer is the beverage of choice among youths. Acknowledging the impossibility of quantifying the relative hazards of different beverages, we conclude that all alcohol should be taxed at the same rate.

The projected effects on sales of doubling the current tax on liquor and then raising beer and wine taxes to the same level are shown in Table 7.

Table 7. Effects of Increased Beer, Wine, and Liquor Taxes*

	Change in Sales (gallons)	Change in Fed. Exc. Tax Revenues (billions)	(percent)
BEER	-12.2%	+$8.81	+581%
WINE			
Table	-20.5%	+$2.40	+2,613%
Fortified	-32.6%	+$.46	+905%
Nat. Carbonated	-4.2%	+$.12	+69%
ALL WINE	-20.6%	+2.98	+934%
LIQUOR	-12.0%	+3.91	+110%
TOTAL	-13.1%	$15.70	+291%

* Doubling the liquor tax and then taxing beer and wine at the liquor rate (per unit of alcohol). The projected $15.7 billion in increased excise taxes would be partially offset by a loss of $3.93 billion in other tax revenues.

Under existing tax laws, malt beverages are all taxed at the same rate, regardless of alcohol content, while liquor products are taxed on the basis of their varying alcohol content. Wine is taxed at several rates, depending on alcohol content and carbonation. We note that basing tax rates solely on alcohol content would result in lower taxes on reduced alcohol beers and wines than for their traditional counterparts, just as lower proof distilled liquors are now taxed at a lower rate. This would serve as an incentive for consumers to choose lower-alcohol products.

The tax increases proposed amount to $1.32 for a six-pack of beer, $1.35 for a 750 ml bottle of wine, and $2.78 for a 750 ml bottle of 80 proof liquor (these estimates include a 20 percent mark-up on the tax increases). On a per-drink basis, these increases amount to 22 cents on a can of beer, 20 cents on 4 ounces of wine, and 17 cents on a 1.5 ounce shot of liquor.

If such tax increases were enacted, we project that they will yield some $12 billion a year in new revenues, an 14 percent decline in alcohol consumption, and a reduction in the costs to society of alcohol problems of roughly $16 billion a year. The new revenue would be more than the total amount of federal income taxes paid by the 23 million taxpayers whose adjusted gross incomes were under $12,000 in 1983.[29] Their tax payments totalled $10.68 billion.

The above projections are based on certain assumptions regarding the effects of tax increases on product prices and the effect of price increases on consumption. Projections for several other combinations of assumptions (-0.1, -0.35, -0.7 price elasticities; 0, 20, 40 percent mark-ups on taxes) are shown in Appendix II. For the lower elasticity, new tax revenues are estimated at about $13.5 - 13.7 billion; for the -0.7 elasticity, revenues are estimated at $8.4 - 10.1 billion.

Legislation should insure that inflation not diminish the value of alcohol taxes in the future as it has in the past. Taxes are not now keyed to inflation. As a result, the nominal $12.50 tax on liquor that was voted in 1984 will be worth only $12 by the time it goes into effect on October 1, 1985. In order that taxes keep pace with inflation and have a progressively greater effect in reducing alcohol problems, we urge that taxes be adjusted annually for inflation. In order to stabilize prices of alcoholic beverages in comparison to the standard of living, taxes should also be adjusted periodically for increases in per capita disposable income.

To maximize the benefits of higher excise taxes, especially to the people who will bear the greatest burden of taxation, a portion of the increased revenues should be earmarked for research, treatment, and prevention activities aimed at reducing the toll of alcohol problems. Another portion should be devoted to training and relocation programs to aid workers who lose their jobs as a result of lower rates of alcohol consumption. A third portion might be shared with states to make up for any lost tax revenues they would incur. Other important health programs could be supported by the remainder.

Officials of alcoholic beverage companies, at times, say that tax increases will cut sales and actually reduce tax revenues. At other times, they say that drinkers will continue to drink and that alcohol problems will not decline. Industry cannot have it both ways: either sales will go down and problems will diminish, or sales will not be affected and tax revenues will rise. It is most reasonable to predict that tax increases will both generate new revenue and reduce alcohol problems.

# # #

Footnotes

1. "Third Special Report to Congress," Nat. Inst. on Alc. Abuse and Alcoholism (1978).
2. "The Effectiveness and Costs of Alcoholism Treatment," Office of Technology Assessment (1983); Research Triangle Institute report to ADAMHA (1983 costs to society due to alcohol abuse calculated at $116.674 billion).
3. "Fifth Special Report to Congress," p. xiii. Nat. Inst. on Alc. Abuse and Alcoholism (1983).
4. The National Institute on Alcohol Abuse and Alcoholism estimates that the cost to Medicare of inpatient and outpatient alcoholism treatment programs in 1981 totalled $155 million ($178 million in 1984 dollars). ("Report to the United States Congress on Federal Activities on Alcohol Abuse and Alcoholism, FY 1981/82", p. 76) DHHS acknowledges that this barely scratches the surface of alcohol-related costs, because it excludes treatment for cirrhosis, cancer, motor vehicle crashes, domestic violence, etc.
5. (a) direct expenses for federal programs: The costs of Medicare, Medicaid, veterans services, Indian Health Service, Department of Defense health programs, and health insurance premiums for federal employees are increased because of alcohol problems. The total cost to the federal government of these programs is $98.7 billion (1984 for Medicare and Medicaid; 1982 figures for other programs). The percentage of these costs related to alcohol can be calculated as follows. According to Health Care Financing Administration (HCFA), total U.S. health expenditures (FY 1984) were $355 billion; according to RTI [2], treatment and support costs for alcohol-related problems in 1983 were $14.865 billion, or $15.5 billion in 1984 dollars. Thus, alcohol is responsible for approximately 4.4 percent of all health care costs. Taking 4.4 percent of $98.7 billion, one can estimate that alcohol is responsible for $4.34 billion in costs to the various federal health programs. To that sum, one needs to add the $62 million budget of NIAAA, indicating a grand total of $4.4 billion.

   (b) productivity losses: RTI [2] estimates productivity losses (goods and services not produced) due to mortality at $18.151 in 1983 and to morbidity at $65.582. RTI (pers. comm., Richard Harwood, July, 1985) estimates further that 15 percent of these amounts are non-marketplace productivity (household services). Thus, marketplace productivity losses amount to $71.2 billion per year. Considering that the federal government employs 4.3 percent of the workforce, and assuming that federal employees have the same rate of drinking problems as other workers, the government's productivity losses due to morbidity and mortality amount to $3.1 billion per year.

   (c) tax losses: The federal government loses corporate income tax revenues due to alcohol-related productivity losses in the private sector. Assuming a marginal tax rate of 25 percent (the figure used by the Congressional Budget Office, pers. comm., Neil Fischer), the federal government loses out on the $18 billion a year in corporate income taxes that would have been paid on this income.

   The sum of these three types of direct and indirect costs and tax expenditures is approximately $25.5 billion per year.
6. "Historical Statistics of the United States; Colonial Times to 1970. Part 2" Series Y 358-373. Bureau of the Census (1976).
7. West, M.D., L.J., (ed), Alcoholism and related problems: Issues for the American Public, The American Assembly, Columbia University; p. 164. (1984); pers. comm., Dept. of Treasury press office.
8. Money not spent on products and services would mean lower taxable profits for the general economy. The Congressional Budget Office assumes that for every new dollar collected from excise taxes, other tax revenues would drop by $0.25. Thus, the $105 billion in additional revenues reflects the difference between $140 billion in higher excise tax revenues and $35 billion in lost corporate and individual tax revenues. Other figures in this paper reflect this net tax gain, except where otherwise indicated.
9. Most states have not been as reluctant to raise alcohol taxes as Congress has. In 1964, federal

tax revenues were more than twice as great as state revenues. In 1983, state revenues ($5.8 billion) out-stripped federal revenues ($5.65 billion). ("1983/1984 Public Revenue from Alcohol Beverages," Table 8, Distilled Spirits Council of the U.S.). Nevertheless, state excise taxes failed to keep pace with inflation: average taxes rose 147 percent between 1964 and 1983, but the consumer price index increased by 221 percent.

10. Toward the Prevention of Alcohol Problems, National Research Council, National Academy Press, Washington, D.C.; Chapter 3 (1984).
11. "Alcohol Policy in Sweden," Swedish Council for Information on Alcohol and Other Drugs. Stockholm (1982).
12. Supra, ref. 3, p. xxiii (1983).
13. Mosher, J.F. and Beauchamp, D.E., "Justifying Alcohol Taxes to Public Officials," Journal of Public Health Policy 4: 4 (1983); also see Bureau of Labor Statistics' consumer price indexes for alcoholic and non-alcoholic beverages.
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We gratefully acknowledge the advice and criticisms of numerous individuals who aided our journey into the murky world of economic forecasts, including Mark Albion, Philip Cook, Allen Ferguson, Eugene Lewit, Stanley Ornstein, John W. Richards, Jr., Isabel Sawhill, and Marvin Schneiderman. Needless to say, these individuals do not necessarily agree with some or all of the assumptions, conclusions, and recommendations that we have made.

# # #

APPENDIX I

The mathematical model for estimating the effects of tax increases on prices and consumption incorporated the following data:

(a) Fiscal year 1984 tax revenues and tax rates (Int. Rev. Serv.).

(b) 1984 sales of total alcoholic beverages (Dept. Commerce).

(c) Estimates of percentage of alcoholic beverage market divided between beer (54%), wine (13%), and liquor (33%) came from Distilled Spirits Council of the U.S. ("Annual Statistical Review 1983/84," Table 48; 1984 breakdown extrapolated from trend in recent years).

(d) Breakdown of wine market between table wine (less than 14% alcohol), fortified wine (14-21% alcohol), and naturally carbonated wine was based on tax revenues (Bureau of Alcohol, Tobacco and Firearms (BATF). (Minor tax categories and varieties of wine were ignored; 81% of wine accounted for in the 3 main tax categories was extrapolated to represent all wine sales).

(e) Domestic taxable wine production data from BATF; wine import gallonages from Census Bureau.

(f) Alcohol content for beer is 4.5% by volume, which averages light and regular beers; alcohol content for table wine, 11.6%, is a weighted average of standard wine and wine coolers (volumes obtained from BATF); alcohol content of wine in the 14-21% alcohol tax category is 20% (BATF); alcohol content of naturally carbonated wine is 12% (BATF).

(g) Average prices of beer ($3.80 per six-pack of 12-ounce cans), table wine ($2.31 per 1/5 gallon), fortified wine ($2.40 per 1/5 gallon), naturally carbonated wine ($5.20 per 1/5 gallon), and liquor ($10.17 per 1/5 gallon of 80 proof liquor) were based on total dollar sales divided by total gallonage sold (derived from tax revenues and knowledge of total dollar volume sold; this combines sales at restaurants, bars, supermarkets, liquor stores, and those made directly from wholesalers to businesses).

(h) Because most statistical data are based on gallons, our estimates were made for 1/5 gallon of wine and liquor rather than 750 milliliters, the current standard size bottle, but the difference is less than 3 percent (1/5 gallon = 726 ml).

(i) Consumer price indexes were obtained from the Bureau of Labor Statistics.

(j) "Costs related to alcohol consumption" were assumed to be proportional to alcohol consumption.

Appendix II

The figures in the body of the paper are based on a price elasticity of -0.35 and a 20 percent mark-up on taxes as products move through the distribution chain. The following table lists revenue increases and decreased costs to society that follow from different assumptions.

Assumptions		Increased Tax Revenues Revenues (gross)	Decreased Costs to Society
Elasticity	Mark-ups	Billions of Dollars	Billions of Dollars
-0.1	0%	18.253	3.915
-0.1	20%	18.090	4.697
-0.1	40%	17.934	5.480
-0.35	0%	16.259	13.701
-0.35	20%	15.701	16.441
-0.35	40%	15.142	19.182
-0.7	0%	13.467	27.402
-0.7	20%	12.350	32.882
-0.7	40%	11.234	38.363

Mr. PEASE. Thank you, Mr. Jacobson.

Mr. Frenzel?

Mr. FRENZEL. I thank the panel for its valuable contribution to our considerations and would like to ask Mr. Jacobson if you believe that every time the Government fails to raise the tax whether the Treasury is losing money.

Mr. JACOBSON. Well, we made a projection as to what the revenue would have been if alcohol taxes kept up with inflation. I think you can look at that as lost money or money that the Treasury might well have received.

Mr. FRENZEL. You can; I don't.

Mr. JACOBSON. I would also refer you to a Treasury Department statement last year at the Senate Finance Committee which recognized the disadvantages of not indexing certain taxes to inflation.

Mr. FRENZEL. If you would like to reduce alcohol consumption, wouldn't it be better to make it illegal—declare it a harmful drug?

Mr. JACOBSON. If that was your—if you want to take every possible step, you might do that. We're not, and members of our coalition are not, advocating any kind of prohibition. We would point out that there is a certain prohibition right now. Most people under 21 are not allowed to purchase alcoholic beverages.

Many members of the coalition believe that there should be a multifaceted effort to deal with alcohol problems, just as members of your committee believe, I assume, that there should be a multifaceted approach to dealing with the budgetary deficits.

Mr. FRENZEL. Does your group have the same feeling about cigarettes?

Mr. JACOBSON. Many of the National Alcohol Tax Coalition's members support higher excise taxes on cigarettes. Because I represent the National Alcohol Tax Coalition, we haven't taken a formal position on cigarette excise taxes.

Mr. FRENZEL. I see. So that's not a part of your presentation.

Well, again I thank the panel for its discussion, and I yield the balance of my time.

Mr. PEASE. The gentleman from California.

Mr. THOMAS. Mr. Jacobson, your indication of increased taxes would reduce the problem and that bringing beer and wine up to alcohol would, I assume, reduce the problem to a certain degree—doubling the taxes on distilled spirits and raising beer and wine—that that would reduce the problem even further?

Mr. JACOBSON. That's right.

Mr. THOMAS. Then quadrupling the taxes and making them equivalent would reduce the problem even further?

Mr. JACOBSON. That's true.

Mr. THOMAS. OK. My question is, How did you arrive at the cutoff point that you're presenting as testimony for this coalition that's significantly concerned—practical taxing policy or how much the system can bear or what?

Mr. JACOBSON. I don't think there's one magic number. A doubling of the tax is a proposal that a number of people—Members of Congress and others—have suggested. Although could not recoup revenues lost or fully adjust for inflation which has occurred since 1951, it would be a reasonable liquor tax rate to establish.

Mr. THOMAS. Is your goal to get back to what it was in 1951 because we didn't have an alcohol problem in 1951?

Mr. JACOBSON. No, it's not. 1951 is one benchmark. One could go back to any other year. 1951 is a reasonable year to choose because that's the year when alcohol excise taxes on beer and wine were last raised.

Mr. THOMAS. Go back to Rome and determine what their taxes were, because they didn't have an alcohol problem?

Mr. JACOBSON. We're not saying that raising the taxes will solve our alcohol problem. Frankly, I don't think our alcohol problem will ever be solved totally. But I think this is one step which will reduce alcohol problems and reduce the budget deficit.

Mr. THOMAS. Now, in reducing the alcohol problem—is it because the increased taxes will reduce consumption or because the increased taxes will be used for educational programs to teach people about the effects of the abuse of alcohol? How are we going to reduce the problem?

Mr. JACOBSON. Our estimation is that it would reduce problems by reducing consumption. Ideally, we would like to see some of the money used for alcoholism treatment and prevention programs.

Mr. THOMAS. But we know that's not true, given the reason that this committee is out looking for money—right?

Mr. JACOBSON. We're not asking that money raised by increasing the alcohol excise tax be earmarked. I think it certainly would be justified to use money raised to save threatened social programs or maintain them at the present rate.

Mr. THOMAS. So my assumption is your basic argument is that by increasing the taxation you'll reduce the consumption, which will help solve the problem.

Mr. JACOBSON. That's right.

Mr. THOMAS. And you don't buy the argument that those people who are the abusers won't cut back if it's increased by a few more pennies in either one of those classes.

Mr. JACOBSON. Some of those people will cut back on their consumption; others won't. Prof. Philip Cook of Duke University's Institute of Policy Sciences did a study of the effect on increased alcohol taxes at the State level. He found correlations with reduced consumption, reduced highway fatalities, and reduced cirrhosis of the liver. His study indicates that heavy drinkers and alcoholics also respond to higher prices.

Mr. THOMAS. I guess my biggest problem is that I agree with you in terms of a societal problem. It's been almost a societal problem in any society, and it perhaps is becoming one because of the mobility and the use of technological equipment which can clearly kill now. You just don't fall over and bump your head; you destroy yourself and others and property. So clearly it's a problem.

But I guess my argument is that we probably ought not to be using the tax system to address that problem. I don't think it's really an effective tool. Your concern is that you're looking for any way possible, and since they're out looking for revenues, this is the time to come in and make that argument as well. I understand that.

I'm not as familiar with the distilled spirit or the beer industry as I am with the wine industry. One of my concerns about ap-

proaching a problem which I guess we both agree is a problem through a taxing procedure is that I'm very clear on what will happen if we reduce consumption through tax increases. And you've indicated that your desire to increase taxes is to reduce consumption. And there is a very—I guess a most direct relationship in the wine industry between those who grow winegrapes and the production of wine.

And I come from a State in which the land is flat, the weather is fair, and when the water is plentiful we can grow anything. And one of the agricultural products we grow are winegrapes. They're not currently subsidized, and to the degree that there is not a market available, they can shift over to a subsidized product and we can then talk about dealing with agricultural problems of an even greater nature.

And I guess one of the concerns that I have is that this committee, in addressing the question of trying to find additional revenue—which I am not supportive of—is focusing on excise taxes with all of the attendant problems of regression, whether or not you believe you can shave the regressivity question. I don't think anybody can argue that excise taxes are not regressive and probably the most regressive taxes.

But it's hard for me to envision this committee and this Congress, which just several years ago passed the Wine Equity Act to talk about clear problems in helping those people in the agricultural industry of winegrape growing, including this committee, which just several months ago in the 1987 trade bill passed a provision which required the administration to update the Equity Act report on the way in which we are removing trade barriers from other countries.

We've rejected this request to increase these taxes several times in the last several years and that every time Clayton Yeutter, our USTR representative, Dick Lyng, our agriculture representative, attends a foreign meeting anywhere in the world they are constantly carrying out our requests to try to knock tariff barriers, nontariff barriers, and other subsidies. We've begun to make some progress in Japan, Taiwan, and the European Economic Community.

And to think that after we're trying to open up international markets for this agricultural product that we're going to sit here and undo an industry from an economic point of view by passing excise taxes which will significantly reduce consumption and which ironically, although you used a wine glass there, I assume that's either a white wine glass or a red wine glass, it probably is not a champagne glass because part of the tax increases you advocate would actually reduce the tax on sparkling wines.

And although it's nice to stereotype in terms of what kinds of taxes are placed on the wine industry, in fact there would be a reduction of taxes if they were equalized on champagne and sparkling wines. And if you go to an alcohol equivalency, you would have a varying array, depending upon obviously the alcohol content of the wine—whether it's distilled wine, a dessert wine, a sparkling wine, or champagne.

And that I just have a hard time believing that we're going to solve a social problem—that I don't think anyone in this room dis-

agrees is a social problem—by slapping a direct tax on an industry which we are trying to promote and have supported in legislation in a number of different ways.

Thank you very much for your testimony.

Mr. PEASE. Thank you, Mr. Thomas.

Let me just ask a question of Mr. Metz and Mr. Schofield. Given the fact that we are required in this committee to find a way to raise $19.3 billion and are looking around for options, none of which are terribly attractive and have had to date no volunteers to have their taxes increased, what is wrong with the reasoning that taxes that have not been raised in 36 years are about due?

Mr. SCHOFIELD. May I respond to that, please, sir?

I think that basically ignores some of the State tax increases which are very heavy on many of the alcoholic beverages, and particularly wine. And over time we have those increases.

I think it also doesn't take into consideration the absolute level of taxation on those products. Look at what other wine producing, grape growing regions of the world like Italy and France—levy in excise tax: Italy has none; France, maybe the equivalent I believe of about 13½ cents a gallon—well below current U.S. Federal rates.

So I would question whether the rate in 1951 was correct and whether today we aren't still being overtaxed to begin with.

So I think those are two basic points, and I also think that we're looking at regressionary kinds of taxation by excise taxes, and we've heard a lot of conversation this morning about that. But I also don't think that it really reflects—the level of excise tax they are proposing reflects the farm economics of today.

And we've got to stop and look at the absolute objective picture today and not the relative. I think that's our main question: is that fair? And our answer is no, it's not fair, when we look at the investment that's been made in vineyard in the United States.

Mr. PEASE. Mr. Metz.

Mr. METZ. Mr. Chairman, the extraordinary shrinkage in the percent of the Federal revenues—from 46 percent in 1934 to about 4 percent—4½ today—I think is an indication by the Congress—a signal that it is increasingly relying upon broader based and more progressive sources of revenue and letting excise taxes, in effect, "attrit" and become a much small proportion of the total income of the Federal Government. We think that's good tax policy.

And if we look at our industry itself since the last Federal tax increase in 1951—at that time the Federal Government took in 3 out of every 4 cents in alcohol beverage excise taxes raised by Federal, State, and local governments. Because the Federal Government has permitted that tax to remain flat and static since 1951, what has happened is that the States now take about 51 cents of every dollar in Federal, State, and local taxation on alcohol beverages. We think that's a positive policy; it ought to be reduced to as low to zero as possible, as far excise taxes at the Federal level.

Mr. JACOBSON. I wonder if I could just add one thing regarding State taxes. We looked at State taxes between 1965 and 1984 for beer and liquor. We discovered that—adjusting for inflation—average State beer taxes declined by 58 percent, and average State liquor taxes declined by 53 percent.

One of the effects of declining taxes—taxes eaten away by inflation—is that according to the January 1987 Economic Report of the President to Congress, the real price of beer has fallen 27 percent, the real price of wine fell 21 percent, and hard liquor 48 percent between 1951 and 1983. A lot of people concerned about alcohol problems are troubled when they see a six-pack of beer going for a smaller price than a six-pack of Pepsi.

Mr. PEASE. I see. OK, thank you very much. I'd like to thank all of——

Mr. THOMAS. Would the gentleman yield briefly?

Mr. PEASE. Mr. Thomas.

Mr. THOMAS. In terms of the 26-year tax increase, I wasn't aware that we used the calendar to determine whether or not taxes ought to be modified. I would hope that we would use a contextual argument as to what the situation is.

Mr. PEASE. Mr. Thomas, it's 36 years, not——

Mr. THOMAS. Thirty-six, fifty-six, a hundred and fifty-six. The calendar ought not to be the thing that determines whether or not we increase taxes.

I think if we're interested in the sin tax area, there are a number of things that we could legalize and then place a tax on it, if it's not now legalized in the system. And perhaps then we could reduce consumption of heroin, cocaine, utilization of prostitution by legalizing them and then taxing them and then increasing the taxes periodically as an attempt to curb the abuse problem. I mean, that kind of logic I don't think advances our argument one inch.

Mr. PEASE. Mr. Thomas, I look forward to having your list of tax suggestions based on other grounds.

Mr. THOMAS. Would the gentleman yield?

I happen to sit on the Budget Committee, and I gave them a series of spending cuts, which if had been followed we wouldn't be carrying on the activity here today.

Mr. PEASE. Mr. Thomas, you were outvoted in the Budget Committee, and we now have the responsibility of raising $19.3 billion. I will look forward to receiving your list of revenue options.

Mr. THOMAS. Mr. Chairman, I look forward to being outvoted on this committee in terms of imposing new taxes on the American people.

Mr. PEASE. Mr. Thomas, I thought maybe that would be your position.

Mr. FRENZEL. Would the gentleman yield?

Mr. PEASE. The gentleman from Minnesota.

Mr. FRENZEL. Parenthetically, I'll say first that the gentleman will probably wait in vain for my list of tax increases as well. But I did want the record——

Mr. PEASE. No hope of getting one from you?

Mr. FRENZEL. I did want the record to show that I had resisted the temptation to ask Dr. Jacobson if he thought capital gains or asset values should be indexed for capital gains tax back to 1951 as well.

I thank the chairman for yielding.

Mr. PEASE. I appreciate the gentleman's forbearance in that matter.

We will again thank the panel and call up the next panel, which consists of Thomas Donohue, Robert McEwen, Dr. Scott, Mr. Gardiner, and Miss Buffone.

Mr. RANGEL. That's the Coalition Against Regressive Taxation, Thomas Donohue; Consumers Opposed to Secret Taxes, Reverend McEwen; American College of Physicians, Dr. Scott; Sierra Club, Mr. Gardiner; and National Clean Air Coalition, Susan Buffone.

Let's start with Thomas Donohue, president of the American Trucking Association.

STATEMENT OF THOMAS J. DONOHUE, CHAIRMAN, COALITION AGAINST REGRESSIVE TAXATION, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN TRUCKING ASSOCIATIONS

Mr. DONOHUE. Thank you, Mr. Chairman. Good morning. My name is Thomas Donohue. I am president and chief executive officer of the American Trucking Associations, and I am appearing today as president of the Coalition Against Regressive Taxation.

CART is an alliance of companies and trade associations from a variety of industries whose customers, workers, and owners—many of them small businesses—pay the bulk of the Federal excise taxes. To put it bluntly, I represent a group of industries that make, sell, or use products that some people feel should be very heavily taxed.

Before you decide to increase taxes on fuel, tobacco, or alcoholic beverages, however, remember who you're taxing. You're not taxing beer, but beer drinkers. You're not taxing big trucks, but owner-operators and family trucking businesses. You're not taxing cigarettes, but tobacco farmers, workers, and mom and pop grocers as well as smokers. You're not taxing wineries, but the thousands of families who by choice or tradition drink wine as a part of their meals.

Obviously, then, you will understand that we oppose increases in Federal excise taxes for deficit reduction for the following reasons. First, they are clearly regressive. They fall on those least able to pay and retract the benefits of tax reform for low-income, working Americans.

Mr. Chairman, with your permission we would like to put in the record a recent study done by Peat Marwick for the coalition which speaks to this matter.

Mr. RANGEL. Without objection.

Mr. DONOHUE. I would just point out two of the issues identified in that study. First, it notes that for workers who earn $10,000 and under, they will lose five times the benefit that they got from tax reform. Second, the study notes that for workers who earn $20,000 and under, they will have an effective increase in their taxes of 136 percent.

The second reason we oppose the increases in excise taxes is that they discriminate by region and geography. For example, sir, the per capita gas use is two times higher in Indiana, Kentucky, and Hawaii than it is in New York. It hurts those that drive to work and those that work in regional industries. Beer, tobacco, wine, and the trucking industry are also affected.

The third reason that we're concerned is that the burden falls on workers and proprietors in a very few industries in this country.

As you heard this morning, tourism, trucking, airlines, distilled spirits, beer, wine, and tobacco and others will carry a disproportionate burden of the responsibility for the Federal deficit.

No. 4, and a very important issue for us, is they discriminate against groups of consumers. What we're asking a small group of the consumers in this country to do—those that drive autos for business, those that operate trucks, minorities, and others—is to pay a disproportionate share of the Nation's responsibility for its deficit.

The fifth reason we oppose them is that they jeopardize the finances of our States. If you look at the source funds for the States in this country, much of them come from excise taxes. State highway taxes are a major source of revenue for safety, transportation, and the movement of goods and people.

The Highway Trust Fund, which is filled with Federal excise taxes—and sir, which by the way has a surplus right now of $13 billion that nobody wants to move because they don't want to affect the deficit any further, all paid for by Federal excise taxes—the Highway Trust Fund and the Airways Trust Fund are put aside to help our States, and I think it's very, very important that we recognize that at present that we're paying $22.7 billion in State excise taxes only in the five industries mentioned in the discussions here in this committee.

Let me finally add a point that was asked about this morning that's not in my statement, but I'd add it. The question was raised by Mr. McGrath this morning about don't we just pass these excise taxes on to the consumer. I'd like to give two very brief answers to that.

No. 1, eventually we do, if we want to stay in business, and eventually it will be paid for by those less able to pay. But in the meantime there is a great deal of problem for the small businesses, for the small trucking firms, for the small distributorships, for the small refiners and others who have to hold that tax in a competitive environment until they can pass it on.

In my industry we've found it very difficult to pass on the 15-cent increase in the cost of fuel over the last 8 months, and it hasn't been passed on.

Let me sum up, Mr. Chairman, by saying that these taxes take away the benefits of tax reform from those least able to pay in a manner that is clearly discriminatory. Second, as I mentioned, they are not easily passed on in a highly competitive environment. Third, the Federal deficit is the responsibility of all taxpayers and citizens, not just a small group of industries and a limited group of consumers.

Finally, I would add my voice to those this morning who suggested that as a nation we need to look to cut spending. But when and if we do that and finally come back to taxes, we need to step up and recognize that the deficit is the responsibility of every citizen, and if there is to be a tax for that purpose, it must be borne by all citizens in an equal and a fair fashion.

Thank you very much, Mr. Chairman.

[The statement and attachment of Mr. Donohue follow:]

BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

Statement on Behalf of
COALITION AGAINST REGRESSIVE TAXATION

HEARING ON
REVENUE-RAISING OPTIONS

July 9, 1987

Thomas J. Donohue
President and Chief Executive Officer
American Trucking Associations

My name is Thomas J. Donohue; I am President and Chief Executive Officer of the American Trucking Associations (ATA), the national federation representing all types and sizes of motor carriers.

SUMMARY

This statement is presented on behalf of the Coalition Against Regressive Taxation (CART). CART is an alliance of companies and trade associations from a variety of industries whose customers, workers, and owners, many of them small businesses, pay the bulk of federal excise taxes. CART does not have a formal membership, but attendees at our recent meetings have come from more than 30 companies and associations that are affected by excise taxes on tobacco, beer, wine, distilled spirits, and highway and airways users.

Participants in CART are united in their opposition to increases in excise taxes as a means to reduce the deficit, whether these taxes go into general revenues, existing trust funds or some type of "deficit reduction trust fund." We oppose these increases for five reasons:

- o They are regressive and undermine tax reform. Families with incomes below $5000 pay from seven to 15 times as great a fraction of income for federal excise taxes on gasoline, beverages and tobacco as do families with incomes exceeding $50,000, according to the Congressional Budget Office (CBO). A more recent study by the Policy Economics Group of Peat Marwick shows that even a $4-5 billion excise tax increases could wipe out the relief promised by tax reform to families with incomes below $10,000.

- o They discriminate by region. For instance, per capita gasoline in Indiana is double that of New York. Tobacco, wine, beer, and distilled spirits taxes each fall on farmers and manufacturing workers in a small number of states. These inequities are especially inappropriate when a tax is increased for a purpose that is everyone's responsibility, such as deficit reduction.

- o They discriminate against narrow groups of consumers. Fuel taxes fall most heavily on those who must drive long distances for work or other nondiscretionary purposes. Tobacco and beverage taxes hit products whose consumers are disproportionately from minority and lower-income groups.

- o They burden workers and proprietors in a few industries. A diesel tax falls hardest on owner-operators and workers and owners of marginal trucking companies, mostly small businesses. Tax-induced cutbacks in gasoline consumption hurt many travel and tourism-related businesses, as well as service stations and oil distributors. Reduced sales of beverages and cigarettes that result from tax increases hurt "mom and pop" stores most, along with growers, producers, and distributors of the respective goods.

- o They jeopardize state finances. Highway users, including the trucking industry, have generally supported use of fuel taxes at the state level to finance road building and repair. Increases in federal taxes that have historically gone to the Highway Trust Fund will reduce state highway user revenues, preclude some states from enacting needed increases, and break the link at both federal and state levels between this revenue source and use of funds.

Individual participants in CART may have their own preference for how to accomplish deficit reduction. CART as an organization does not take a position on issues other than excise taxes.

REGRESSIVITY AND UNDERMINING TAX REFORM

The evidence that excise taxes are regressive and contrary to the intent of the Tax Reform Act is overwhelming. In January, a CBO staff working paper found, "The average increase in [excise] taxes as a percentage of total income would be about twice as large (more than three times as large in the case of the tax on beer or tobacco) for families with incomes between $10,000 and $20,000 compared to families with incomes of $50,000 or more." ("The Distributional Effects of an Increase in Selected Federal Excise Taxes," p.2)

In May, CART released a study it had commissioned from a leading independent researcher, Policy Economics Group of Peat Marwick. That report, "An Analysis of the Regressivity of Excise Taxes," which has been submitted for the record, confirms recent CBO findings on the regressivity of gasoline, tobacco, beer, wine, and distilled spirits taxes. It also shows how quickly increases in these taxes would overwhelm the relief for low-income families that was promised by the Tax Reform Act of 1986.

The study assumed for illustrative purposes that the fiscal 1988 revenue target would include $18 billion from the five excise taxes listed above. This would result in a near-doubling of each tax. Using a data base and methodology comparable to that of the Joint Committee on Taxation and CBO, the report found that this package would produce a tax increase for families with less than $10,000 of income nearly five times as great as the tax relief enacted last year.

That income group is estimated to receive income tax relief totaling $414 million once the Tax Reform Act becomes fully effective. The excise tax increase would total nearly $2 billion. Even a tax increase of just 5¢ per gallon for gasoline, or a comparable rise of $4-5 billion in the other excise taxes, would eliminate any tax savings for this income class.

Another recent report, "Meeting the Revenue Targets in the 1988 Budget: Will Tax Reform Be Extended or Undermined?" (May 1987), by Citizens for Tax Justice (CTJ), also confirms how unfair excise tax increases would be for the group least able to pay.

The regressivity cannot be cured merely be increasing the earned income credit. That credit only reaches families with earned income and does not help those who are retired or

unemployed. Moreover, the credit bears no relation to individual consumption patterns, which is essential to compensate for taxes on selected consumption items. Other solutions quickly become far too expensive and/or complex. In short, the only "fix" for the regressivity problem is to avoid increasing excise taxes altogether.

DISCRIMINATION AGAINST SELECTED POPULATION GROUPS

The CBO and other studies make the conventional assumption that the full amount of an excise tax increase would be passed through to consumers in proportion to their current consumption of taxed products. In fact, as the CBO study points out, there are a variety of effects, depending on the degree to which the taxes are passed forward. Unfortunately, the complete picture is more complex but no more comforting: under any set of assumptions, these taxes hurt those least able to pay.

Besides discriminating against the poor, these excise taxes vary greatly by region, demographic characteristics, occupation, and industry. There is no justification for such inequities when the goal is a national one such as deficit reduction, which should be borne by all taxpayers.

The degree of pass-through varies by elasticity of supply and demand for each product. For instance, in trucking, competitive conditions have prevented most firms from passing through the 15¢ increase in diesel prices that has occurred since last winter. A similar tax increase would be equally hard to pass through, and many owner-operators and marginal companies would be driven out of business before prices rose enough to cover the cost of the tax.

There would be geographic discrimination. Gasoline use per capita in Indiana and Kentucky is roughly double that for New York, Hawaii and the District of Columbia, according to the Highway Users Federation. As a percentage of income, the CTJ report shows that a gasoline tax would fall most heavily on southern and western states. Within states, the tax discriminates against rural and small-town residents, who do not have the option of public transit and often must travel long distances for any purpose.

Farm production of crops used for cigarettes, beer, wine, and some distilled spirits is likewise concentrated in a few states--indeed within limited regions of those states. Winery, distillery, and tobacco factory workers, who along with farmers would bear the brunt of tax-induced cutbacks in demand, are also geographically concentrated. Many have limited alternative job prospects.

The demographic implications of these taxes are also unsavory. The gasoline tax singles out large families that require larger and less fuel-efficient vehicles. It also targets those who depend on an automobile for their livelihood, either for their own job or because they work in travel, tourism, fuel, or automotive service fields. Other taxed products are used disproportionately by minority groups.

Job losses from increasing these taxes are likely to be highest among small businesses. For instance, in trucking, it is the owner-operator and the marginal, usually small, company that will have the most difficulty absorbing or passing on an increase in diesel taxes. "Mom and pop" stores are the most dependent of any outlets on sales of tobacco and alcohol beverages and the most sensitive to tax-induced cutbacks in consumptions. Similarly, the small roadside or corner auto-related business is far more vulnerable than the large oil or vehicle producer to effects of a gasoline tax hike.

Some proponents of higher excise taxes try to mask their proposals as public health measures. But these arguments are incomplete and misleading. For instance, when the cigarette tax was doubled in 1982, an estimated 14,600 tobacco growers and workers lost their jobs; that cost must be weighed against any assumed health benefits. As another example, the vast majority of those who consumer beer do so moderately. The tens of millions of Americans who drink beer responsibly, without exacting any cost on society, should not be penalized for the abusive behavior of a small minority. And to argue that the small minority of abusers of beer or other alcohol beverages will refrain from abuse as a result of higher taxes is nonsense.

EFFECTS ON STATE FINANCES

Several industries represented in CART pay even more in state excise taxes than in federal ones. States have been turning increasingly to excise taxes as a source of added revenues. For instance, in the past 30 years, state excise taxes on beer have increased by approximately 600%. From 1982 to January 1987, state diesel fuel taxes have risen 36%; this year 18 states have put increases into effect, with several others pending. (This is on top of a 275% federal diesel tax increase since April 1983.) Since fiscal 1981, 38 states have raised their cigarette taxes (and the federal tax has doubled). Distilled spirits taxes gave been raised in 41 states since 1980 (and the federal tax went up 19% in 1985). In the same period, 36 states have enacted wine tax increases. (Details on these changes are available from CART.)

Increases in federal excise taxes will reduce consumption and hence state revenues. Increases may also preempt states from increasing the same taxes. Moreover, for taxes that have historically gone into highway or other trust funds, the use of that revenue source for general revenues at the federal level is a damaging precedent at both federal and state levels. It is no wonder, then, that a wide range of organizations representing officials of state, county and municipal governments has opposed one or more federal excise tax increases.

ALTERNATIVES

CART takes no position on proposals other than increases in excise taxes. Each member may have its own position. For instance, the trucking industry does support improved collection procedures for the diesel tax. Currently, $300 million a year, according to Federal Highway Administrator Ray Barnhart, and much more according to other estimates, of this tax is not being collected. The trucking industry is generally paying this tax at the pump, and wants to make sure that the money gets into the Highway Trust Fund instead of being siphoned off.

CONCLUSION

All of the options presented to the committee for raising excise tax rates are unacceptable for the reasons stated above. These objections apply whether the rate increase is explicit or disguised as indexation, equalization, or implicit income tax offsets.

CART's business members have been joined in their opposition by an unusual assortment of interest groups, representing labor, consumers, minorities, and state and local governments among others. We believe this breadth of opposition is further strong evidence of the error of increasing excise taxes.

AN ANALYSIS OF THE REGRESSIVITY OF EXCISE TAXES

(By the Policy Economics Group of Peat Marwick Main & Co.)

EXECUTIVE SUMMARY

This report presents the results of a detailed analysis of the distributional impact of excise taxes on gasoline, alcohol beverages and tobacco in comparison to the Federal personal income tax and the social security payroll tax. The analysis of alcohol beverage taxes is disaggregated between beer, wine, and distilled spirits.

The analysis was made using recent data from a wide variety of sources. These data were incorporated into the analysis using sophisticated statistical techniques and the Policy Economics' Federal tax model and data base.

All the excise taxes examined in this report were found to be regressive. The social security payroll tax was also found to be regressive, though less so than any of the excise taxes, and the individual income tax was found to be progressive.

The analysis disaggregates the effects of the taxes examined between the aged and non-aged population. The results show that the average excise tax rate is greater for the aged than for the non-aged. The reverse is the case for income and payroll taxes.

The report presents the potential distributional effects of excise tax increases currently being considered by the Congress in its deliberations on the 1988 budget. An excise tax increase of as much as $18 billion is currently being considered in these deliberations. The report shows that an excise tax increase of this magnitude would raise the taxes of low income taxpayers disproportionately and would substantially more than offset the income tax reduction these taxpayers received from the Tax Reform Act of 1986.

This is highlighted in the table below, which compares the distributional effect of an $18 billion increase in excise taxes to the reduction in income taxes enacted in the Tax Reform Act of 1986. It shows that, for families with incomes of less than $10,000, the excise tax increase is nearly 5 times as great as the income tax reduction.

Comparison of Enacted Income Tax Reductions and Potential Excise Tax Increases

Income Class ($000's)	Income Tax Reduction	Excise Tax Increase	Net Tax Change	Excise Tax Increase as a percent of income tax reduction
	($ Millions)			
< 10	-$414	$1,981	+$1,568	479%
10 - 20	-2,983	2,653	-329	89
subtotal	-3,397	4,635	+ 1,238	136
20 - 30	-3,319	2,836	-483	85
30 - 50	-8,112	5,366	- 2,746	66
50 - 100	-7,609	4,324	- 3,284	57
subtotal	-19,040	12,526	-6,513	66
100 - 200	-3,572	610	-2,963	17
200 >	-9,689	229	-9,460	2
subtotal	-13,261	839	-12,423	6
Total	$-35,698	$18,000	$-17,698	50%

INTRODUCTION

This report presents an analysis of the distributional effects of the Federal personal income tax, the social security payroll tax, the gasoline excise tax, the tobacco excise tax, and alcohol excise taxes. The analysis of alcohol tax burdens is disaggregated between taxes on distilled spirits, wine, and beer.

The report is organized into four sections. The first section discusses alternative approaches to measuring excise tax burdens and summarizes briefly the results of two studies on this subject. The second section analyzes the method used for measuring the distributional effects of the different taxes. It describes the expanded income concept used in the calculation and the Gini coefficient and Lorenz curves used in the analysis. The third section describes the sources of data used in the analysis and the statistical methods employed to transform these data to meet the needs of this study. The final section presents the results of the analysis.

The report includes an appendix that presents the data used in developing the statistical analysis and the sources of these data.

I. EXCISE TAX BURDENS: BACKGROUND

There are essentially two alternative approaches to evaluating the distributional impact of taxes. One approach, which is used in this study, is to analyze the tax burden, or effective tax rate, by income level for the tax or taxes being analyzed. Summary measures of the distributional impact can then be calculated from these effective tax rates by income class. This is the best approach for analyzing tax burden impacts, because the tax burden can be measured and assessed at a number of specific income levels. This approach is the most difficult to undertake, however, because it requires specific data on tax burdens at different income levels, and these data are not always readily available.

An alternative approach is to estimate the relationship between tax collections and income and make summary judgments about the distributional impact of the tax from this relationship. If the responsiveness of tax revenues to income, i.e,, the income elasticity, is greater than one, tax burdens can generally be expected to be higher at high income levels than at lower income levels. If the income elasticity is less than one, the reverse is the case. Studies that estimate the distributional impact in this way have the advantage of not requiring data on tax burdens by income class. Time series or cross-section data can be used to make these assessments. The disadvantage is that the distributional impact is measured in a single number; no data are available by specific income classes.

Measurement of Tax Burdens by Income Class

One of the major principles for measuring the equity of a tax is the "ability to pay" principle, which requires equal taxation of people with equal ability and, for people with unequal ability, increases in taxation as ability to pay increases. One of the fundamental ways to measure the burden of a tax relative to the

ability to pay is to calculate the dollar tax payment as a percent of household income. The tax is said to be progressive, regressive, or proportional if the tax, as a percent of household income, rises, falls or remains constant as household income rises. For example, consider the following table displaying hypothetical income and tax data.

Table 1

Tax Burden Under Three Hypothetical Taxes

	Income			
	$10,000	$25,000	$50,000	$100,000
Tax 1:				
Dollars	$1,000	$2,500	$5,000	$10,000
Percent of Income	10%	10%	10%	10%
Tax 2:				
Dollars	$1,000	$3,000	$7,500	$18,000
Percent of Income	10%	12%	15%	18%
Tax 3:				
Dollars	$1,000	$2,000	$3,000	$4,000
Percent of Income	10%	8%	6%	4%

Clearly, tax 1 is proportional, tax 2 is progressive, and tax 3 is regressive. (Note that in all cases, however, higher income persons pay more tax under each of these three hypothetical taxes.)

One major study that analyzes the distributional impact of excise taxes using data on tax payments by income classes was done by Donald Phares in 1980. His study, which analyzed the distributional impact of all major state and local taxes, used data from the Bureau of Labor Statistics 1978 Consumer Expenditure Survey as the basis for assessing the distributional impact of consumption-based taxes. His results, reported in Table 2, show that the effective tax rate on excise taxes declines sharply as income rises.

Table 2

Effective Tax Rates Of Selected Consumption Based Taxes As Estimated By Donald Phares[1/]

(tax as a percent of income)

Income Class	Tobacco Tax	Alcohol Tax	Motor Fuels Tax	General Sales Tax
Under $3,000	1.18	0.34	2.25	5.02
3,000 to 3,999	0.67	0.25	1.40	3.49
4,000 to 4,999	0.55	0.23	1.20	3.12
5,000 to 5,999	0.48	0.21	1.06	2.87
6,000 to 6,999	0.43	0.21	0.99	2.75
7,000 to 7,999	0.39	0.20	0.92	2.64
8,000 to 9,999	0.34	0.19	0.83	2.47
10,000 to 11,999	0.30	0.19	0.75	2.34
12,000 to 14,999	0.27	0.18	0.68	2.20
15,000 to 19,999	0.23	0.17	0.61	2.06
20,000 to 24,999	0.20	0.17	0.57	1.97
25,000 to 29,999	0.18	0.17	0.53	1.91
30,000 to 35,000	0.17	0.16	0.51	1.83
Above $35,000	0.14	0.15	0.45	1.63

Note: The effective tax rates shown above reflect the average state and local tax rates as a percentage of income based on 1978 data.

1/ Phares, Donald, Who Pays State and Local Taxes?, Cambridge, Mass.: Oelgeschlager, Gunn (1980).

A second and more recent study, prepared by the U.S. Congressional Budget Office, examined the distributional effects of major federal excise taxes. The distributional effects were measured relative to a broad-based definition of family income similar to that used in this study, and to total family expenditures. The distributional estimates were based on the income and expenditure data in the 1982-83 Consumer Expenditure Survey (CES). The estimates measured relative to family income are presented in Table 3 and again show that excise tax rates decline sharply as incomes rise.

Table 3

Effective Tax Rates For Expenditures
Subject to Federal Excise Tax: 1985
As Estimated by the Congressional Budget Office 1/

Income Class	Tobacco Tax	Alcohol Taxes			Gasoline Tax	Telephone Tax	Airfare Excise Tax
		Beer	Wine	Liquor			
Under 5,000	1.05	0.37	0.07	0.75	1.62	0.61	0.43
5,000 - 9,999	0.44	0.12	0.02	0.24	0.58	0.21	0.14
10,000 - 19,999	0.29	0.10	0.02	0.20	0.50	0.14	0.12
20,000 - 29,999	0.21	0.07	0.02	0.16	0.41	0.11	0.10
30,000 - 39,999	0.17	0.07	0.01	0.14	0.35	0.09	0.08
40,000 - 49,999	0.13	0.05	0.01	0.12	0.31	0.08	0.09
50,000 or More	0.07	0.04	0.01	0.11	0.22	0.07	0.09
Total	0.17	0.06	0.01	0.15	0.35	0.10	0.10

1/ U.S. Congressional Budget Office, "The Distributional Effects of an Increase in Selected Federal Excise Taxes," Staff Working Paper, January 1987.

II. METHOD OF ANALYZING DISTRIBUTIONAL IMPACT

In assessing the distributional impact of taxes, two important conceptual issues and one important analytic issue arise. The conceptual issues relate to 1) the incidence of taxes and 2) the measure of income used. The analytic issue relates to the method used to summarize the distributional data and establish a framework that permits comparisons between different taxes.

Incidence of Taxes

The incidence of taxes is critical to any distributional analysis. The distributional impact of a payroll tax, for example, will differ depending upon whether the tax is passed forward to consumers through higher product prices, is borne by wage earners, or is passed back to employers.

A detailed discussion of tax incidence is beyond the scope of this paper, but it is important to state explicitly the incidence assumptions that have been made. It is assumed that the personal income tax is borne by the income earner; the payroll tax is borne by the wage earner; and consumption taxes are borne by the consumer. These are conventional assumptions that are generally consistent with previous economic research.

Income Measure

The estimated distributional impact of taxes can vary by the income definition used in the analysis. The major conceptual issue in the literature is whether "permanent" or current income should be used. Permanent income was first discussed by Milton Friedman when he separated income into a permanent and a

transitory component.[1/] Friedman argued that changes in transitory income would have less effect on consumption (and, therefore, consumption-based taxes) than permanent income.

This issue is potentially important to analyses of the distributional impact of consumption-based taxes. If individuals have low current incomes because of temporary factors, such as unemployment, their consumption may not be affected to the same degree as their income change. The same applies to individuals who have unusually high current incomes due to temporary factors, such as irregular bonuses. The use of current income, therefore, can overstate the degree of regressivity of consumption-based taxes.

One major problem with the permanent income hypothesis for empirical studies is that it is not directly measurable, and proxy measures such as the average income level over some period of years, require more data than are generally available. A second argument that has been made against using permanent income is that "...taxes must be paid when they come due, and the more that has to be paid at any one time, the less is left for private use at that time."[2/] For these reasons, most empirical studies of tax burdens use some measure of current income as the basis for the analysis.[3/]

1/ Milton Friedman, A Theory of the Consumption Function, Princeton, N.J.: Princeton University Press, 1957.

2/ Richard A. and Peggy B. Musgrave, Public Finance in Theory and Practice, 2nd ed., New York: McGraw-Hill, 1976, p. 443.

3/ The previously cited Congressional Budget Office study used consumption (as a proxy for permanent income) as one of two measures of ability to pay.

The current income concept used in this report is a broad-based measure of income. This measure includes income sources that are not currently included in the income tax base, such as transfer payments, certain fringe benefits (including employer contributions for social security), and interest from tax-exempt State and local bonds.

Summary Measures of Distributional Impact

If one wishes to compare the burdens of two or more taxes, it is useful to derive an index of tax burden that can be applied across taxes. Such indexes can be found in the literature on income distribution. Lorenz curves and Gini coefficients, common measures of income distribution, are modified in the present report to measure the burden of several U.S. taxes.

The Lorenz curve was originally designed to measure the income distribution of an economy by plotting the accumulated percent of total family income on the vertical axis and the accumulated percent of families on the horizontal axis (see Figure 1). An equal distribution of income is represented by the 45 degree line OR. The Lorenz curve OSR represents an unequal distribution because 50 percent of the families have less than 50 percent of total family income. The further OSR bows away from OR, the greater is the inequality of income distribution.

To measure the degree of this inequality, the Gini coefficient takes the ratio of the area between OR and OSR to the area of triangle OPR. The greater the inequality, the greater is the area between OR and OSR, and the closer the Gini coefficient is to unity. Thus, the Gini coefficient ranges from 0, where there is exact equality in the distribution of income, to 1, where all income is concentrated in one family.

The Lorenz curve and Gini coefficient concepts can be modified to analyze tax burden distributions. In Figure 2, the accumulated percent of household income is plotted on the

Figure 1

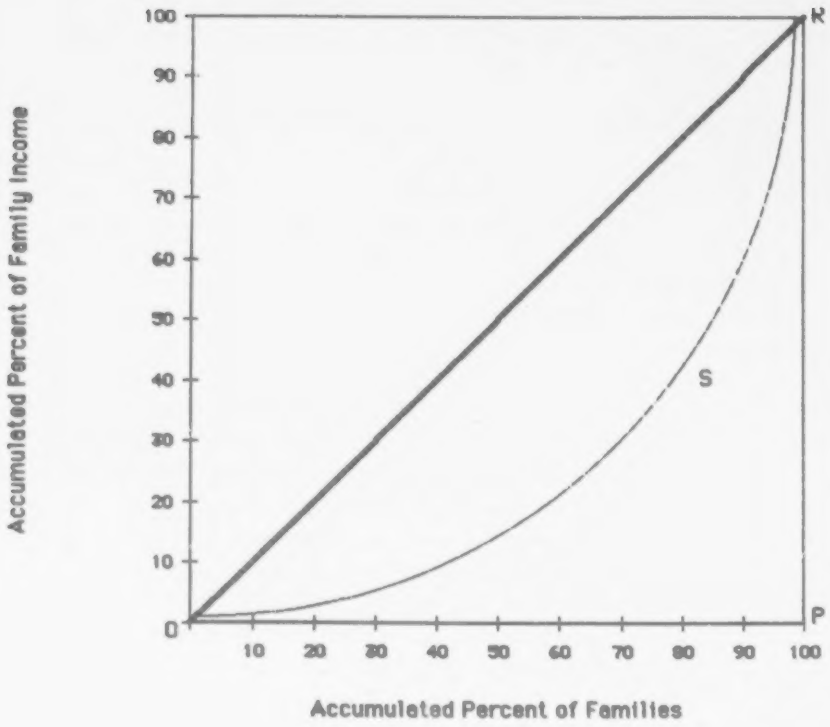
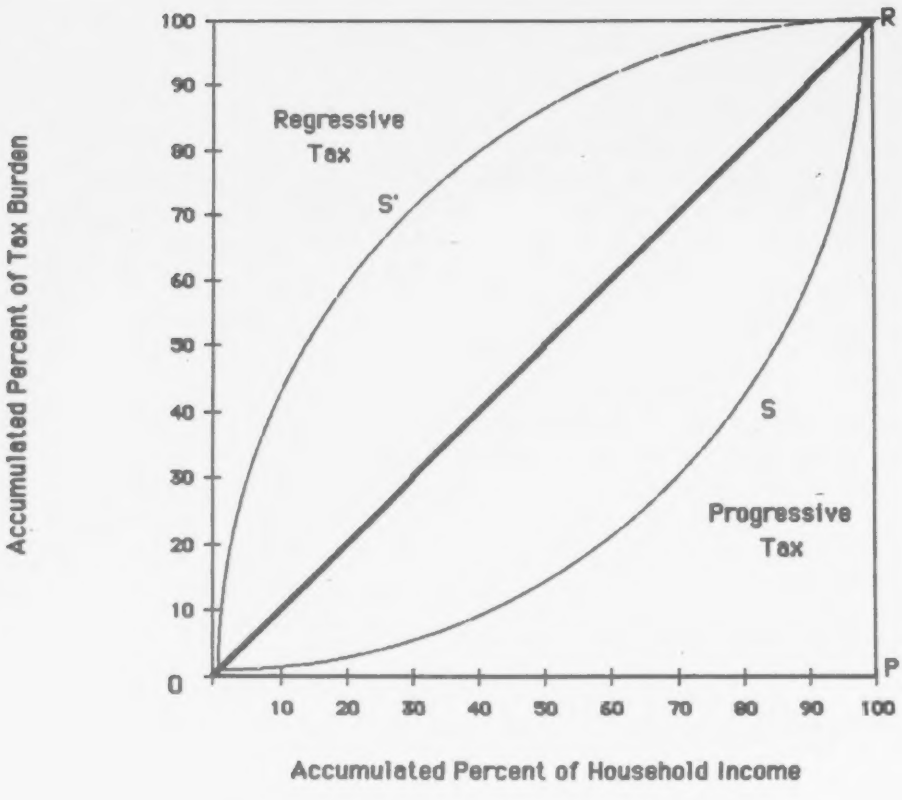

Accumulated Percent of Family Income
100
90
80
70
60
50
40
30
20
10
0
R
S
P
10
20
30
40
50
60
70
80
90
100
Accumulated Percent of Families

Figure 2


100
90
80
70
60
50
40
30
20
10
0
R
P
Regressive
Tax
S'
S
Progressive
Tax
10
20
30
40
50
60
70
80
90
100
Accumulated Percent of Household Income
Accumulated Percent of Tax Burden

horizontal axis and the accumulated percent of tax burden on the vertical axis. Following the procedure of Daniel B. Suits[3/], if the area of triangle OPR is designated as K and the area under the Lorenz curve as B, then the income tax burden (I) is defined as:

$$I = (K-B)/K,$$
$$= 1-(B/K)$$

The Lorenz curve OSR represents a progressive tax because the poorest 50 percent of the households pay less than 50 percent of the tax while the wealthiest 50 percent pay more than 50 percent of the tax. In this case, area B is less than area K and $I > 0$. Lorenz curve OS'R represents a regressive tax because the poorest 50 percent of the household pays more than 50 percent of the tax while the wealthiest 50 percent pay less than 50 percent of the tax burden. Area B is greater than area K and $I < 0$. Line OR represents a tax whose burden is equally distributed among the households. Therefore, I can range from -1 to +1. The closer I is to -1, the greater is the tax regressivity and the burden on low income classes; the closer I is to +1, the greater is the tax progressivity and the burden on high income classes. If $I = 0$, the tax is proportional and the burden is equally distributed among income classes.

3/ Suits, Daniel B., "Measurement of Tax Progressivity," American Economic Review, 67 (September 1977), pp 747-752.

III. SOURCES OF DATA

This section presents the data used in the analysis of the distribution of tax burdens. The first part of this section shows the control totals for receipts in 1986 for each of the major revenue sources analyzed in this report. The second part discusses the sources of data for allocating these tax burdens by income class.

Control Totals

Table 4 shows the aggregate levels of receipts in 1986 for the revenue sources discussed in this report. The footnotes to that table show the sources of these data. For individual income taxes, and social security payroll taxes, only the Federal tax is analyzed in this report. For the other taxes, Federal and state taxes are considered in the distributional analysis. The state taxes are included as national weighted averages and are, therefore, distributed the same as their Federal counterpart; their inclusion, therefore, affects the level of affected tax rates but it does not affect the distribution of tax rates among income classes.

Data on Distribution of Tax Burdens

The sources of data on the distribution of tax burdens by income class come from several sources, as described below.

Federal individual income taxes and social security payroll taxes are calculated using the Policy Economic Group's federal tax model and data base. This data base includes a sample of approximately 300,000 observations, 50 percent greater than the sample size used by the U.S. Treasury Department for analyzing Federal income tax issues--and the computer model contains more than 10,000 lines of computer coding to calculate Federal income and FICA tax liabilities.

Table 4

1986 Tax Revenues
(millions of dollars)

	Federal	State	Total
Federal individual income tax[1/]			
Prior Law	352,583	na[2/]	na[2/]
Tax Reform Act of 1986	316,885	na[2/]	na[2/]
Social security payroll tax[3/] (employee share)	123,500	na	na
Excise Taxes:			
Gasoline excise tax[4/]	9,327	15,260	24,587
Tobacco excise tax[5/]	4,468	4,622	9,090
Alcohol excise tax[6/]			
Beer	1,499	1,032	2,531
Wine	415	288	703
Distilled spirits	3,688	1,456	5,144
Total Excise Taxes	19,397	22,658	42,055

Sources:

1/ Policy Economics Group federal income tax model. Data are for calendar year 1986. Data for the Tax Reform Act are for fully phased-in tax law.

2/ State income taxes were not included in this analysis. State income tax structures vary significantly from state to state and their aggregate distribution is likely to vary significantly from the Federal income tax. For this reason, it would be misleading to assume that state income taxes have the same distributional effects as the Federal income tax.

3/ Social Security Administration, unpublished data. Data are for calendar year 1986.

4/ Bureau of Economic Analysis, U.S. Department of Commerce, unpublished data. Data are for calendar year 1986.

5/ Tobacco Institute, The Tax Burden on Tobacco, 1986. Data are for fiscal year 1986 ending June 30, 1986.

6/ Federal data are from the Distilled Spirits Council of the United States and are unpublished. The statistics are for fiscal year 1986 ending September 30, 1986. The state data were estimated by the Policy Economics Group based on historical trends. These data are also for fiscal year 1986.

Gasoline excise taxes are estimated based on data from the Bureau of Labor Statistics 1983 Consumer Expenditure Survey, which shows the distribution of gasoline and oil expenditures by income class. On the basis of these Survey data, gasoline consumption was imputed to each taxpayer in the Policy Economic Group's data base.

Data on alcohol beverage consumption are from Simmons Market Research Bureau, which conducted a survey of approximately 20,000 individuals in 1985. This survey recorded information on the economic and demographic characteristics of the drinking population, and on the level of consumption for each category of drinker. Appendix Table A-1 summarizes the Simmons data.

On the basis of these data, a statistical imputation was made to the Policy Economic Group's Federal data file to "identify" drinkers and non-drinkers, consistent with the percentages in Appendix Table A-1. For the drinking population that resulted from this statistical procedure, the volume of consumption was then imputed in a similar manner consistent with the data in the same table.

Data on tobacco consumption are taken from two sources and are summarized in Appendix Table A-2. Data on the percentage of males and females age 20 and above who smoke, and the amounts that they smoke, are derived from the U.S. Department of Health and Human Services 1986 National Health Interview Survey, which sampled 100,000 adults age 20 and above. Data for persons under age 20 were derived from a 1985 household survey conducted by the Alcohol, Drug Abuse, and Mental Health Administration.

On the basis of these data, a statistical imputation identical to that described for drinkers was made to the Policy Economic Group's microsimulation data base to identify smokers and the amounts that they smoked.

The discussion above relates to the measurement of tax burdens on individuals from their personal consumption of the taxed products. Some excise taxes are in fact paid by businesses from their purchases of taxed products. Excise taxes paid by business were distributed to all consumers in proportion to their consumption of total goods and services. Specifically, 20 percent of gasoline and alcohol taxes were distributed in this manner.

IV. PRESENTATION OF RESULTS

This section presents the empirical results from the detailed statistical analysis performed by Policy Economics. The first part compares the distributional impact of each of the excise taxes analyzed in this report to income and payroll taxes. It shows that the excise taxes are highly regressive. The second part presents estimates of the tax burden for the aged and non-aged. It shows that, in the aggregate, excise tax burdens are greater for the aged population than the non-aged population.

Distribution of Excise Taxes Relative to Other Taxes

Tables 5 and 6 show the distribution of the tax burden in 1986 among seven different income classes for each of the taxes analyzed in this report. Table 5 shows the tax burden for each income class as a percentage of income within that income class. These percentages represent effective tax rates for each tax by income class. This table permits an assessment of both the distributional impact of the tax and the relative size of the different taxes by income class.

Table 6 shows the percentage of the total tax burden for each tax that is absorbed by each of the seven income classes and for sub-aggregates of these income classes. This table provides a useful comparison of the relative progressivity or regressivity of the different taxes. It also shows the Gini coefficients for each of the different taxes. As noted earlier, a positive value for the Gini coefficient indicates that the tax is progressive and a negative value indicates it is regressive.

Table 5

Effective Tax Rates: Tax Burden as a Percent of Income
by Income Class

Income Class ($000's)	Federal Individual Income Tax		Social Security Payroll Tax	Tobacco Excise Tax	Gasoline Excise Tax	Alcohol Excise Taxes			Total Excise Taxes
	Prior Law	Tax Reform Act of 1986				Beer	Wine	Distilled Spirits	
< 10	1.154	0.693	2.236	1.285	2.724	0.370	0.082	0.624	5.085
10-20	3.927	2.773	3.294	0.565	1.263	0.156	0.040	0.326	2.350
20-30	6.855	6.023	3.906	0.396	0.927	0.105	0.026	0.198	1.652
30-50	9.181	8.356	4.346	0.276	0.768	0.070	0.021	0.149	1.284
50-100	11.405	10.706	4.258	0.169	0.587	0.052	0.016	0.114	0.938
100-200	16.820	15.380	2.623	0.103	0.358	0.035	0.010	0.072	0.578
>200	23.748	19.771	0.736	0.035	0.144	0.013	0.004	0.027	0.223
AVERAGE	10.649	9.571	3.730	0.275	0.743	0.077	0.021	0.155	1.271

Table 6

Distribution of Tax Burden by Income Class

(Percent)

Income Class ($1,000's)	Percent of Economic Income in Each Income Class	Federal Individual Income Tax		Social Security Payroll Tax	Tobacco Excise Tax	Gasoline Excise Tax	Alcohol Excise Taxes			Total Excise Tax
		Prior Law	Tax Reform Act of 1986				Beer	Wine	Distilled Spirits	
0-10	2.7	0.3	0.2	1.6	12.7	9.9	13.1	10.4	10.9	10.8
10-20	7.8	2.9	2.3	6.9	16.1	13.3	15.9	14.6	16.4	14.4
Subtotal, Low to Moderate Income	**10.5**	**3.2**	**2.5**	**8.5**	**28.8**	**23.2**	**29.0**	**25.0**	**27.3**	**25.3**
20-30	12.1	7.8	7.6	12.6	17.4	15.1	16.5	14.9	15.3	15.7
30-50	29.7	25.6	25.9	34.6	29.9	30.7	27.3	29.8	28.5	30.0
50-100	32.9	35.2	36.8	37.6	20.2	26.0	22.5	25.2	24.1	24.3
Subtotal, Middle and Upper Middle Income	**74.6**	**68.6**	**70.3**	**84.8**	**67.5**	**71.7**	**66.3**	**70.0**	**68.0**	**70.0**
100-200	7.5	11.8	12.0	5.3	2.8	3.6	3.4	3.7	3.5	3.4
>200	7.4	16.4	15.2	1.5	0.9	[illegible]	1.3	1.4	1.3	1.3
Subtotal, High Income	**14.9**	**28.2**	**27.2**	**6.7**	**3.8**	**5.0**	**4.7**	**5.0**	**4.8**	**4.7**
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Gini Coefficient	**N.A**	**+0.23**	**+0.23**	**-0.05**	**-0.35**	**-0.25**	**-0.32**	**-0.27**	**-0.29**	**-0.28**

All of the results are within the range of a priori expectations. The Federal individual income tax is shown to be the only progressive tax of those analyzed, with all other taxes being regressive. Of the regressive taxes, the excise taxes on tobacco and beer are the most regressive. The distributional results for each of the taxes are described briefly below.

Federal individual income taxes.--The Federal individual income tax is widely recognized to be a highly progressive tax. This progressivity results from both the progressive rate structure and from the personal exemptions and zero bracket amounts that are a part of this tax structure. The average Federal income tax rate in 1986 was 10.6 percent, as shown in Table 5. Under the provisions of the Tax Reform Act of 1986, when fully phased in, this tax rate will drop to 9.6 percent.

As Table 5 shows, the average effective income tax rate was substantially higher for high income taxpayers than for low income taxpayers. For taxpayers with incomes between $10,000 and $20,000, for example, the rate averaged 3.9 percent of income, whereas for taxpayers with incomes above $200,000 this rate averaged 23.7 percent of income. Table 8 shows that 28 percent of these taxes were paid by high income taxpayers, a substantially higher percentage than for any other tax. Consistent with this distributional impact, the Gini coefficient is estimated to be +0.23 under both prior law and the Tax Reform Act. These are the only estimated Gini coefficients with a positive sign.

Social security payroll taxes (employee share).-- Social security taxes are shown to be regressive at the high income levels. This result reflects the fact that the social security payroll tax is a single rate applicable to wages up to a statutory

maximum ($42,000 in 1986), with no tax imposed on wages above that level. The measured regressivity also reflects the fact that the average wage share of income diminishes as incomes rise.

The average social security tax rate in 1986 was approximately 3.7 percent of income. As noted above, this rate reflects only the employee share of this tax. If the employer share were included on the assumption that employees bear this portion of the tax as well (as conventional economic wisdom suggests) this rate would be twice as large. The distribution of the tax burden across income classes would, however, be the same.

As shown in Table 6, only 6.7 percent of social security payroll taxes are borne by households with incomes above $100,000, roughly one-fourth the comparable percentage for income taxes. Similarly, 8.5 percent of social security taxes are borne by low to moderate income households, about three times the comparable percentage for income taxes.

Tobacco excise taxes.-- Tobacco excise taxes are estimated to average 0.275 percent of total income of all taxpayers. The average tax rate in the low income classes is substantially higher than the average; for the high income classes, the reverse is the case. In the lowest income class, for example, the tax averages 1.3 percent of income whereas in the top income class it is only 0.035 percent of income. Table 6 shows that 28.8 percent of tobacco excise taxes are paid by low to moderate income earners, a higher percentage than for any other tax except beer, which is 29.0 percent. The Gini coefficient is -0.35 for tobacco taxes, the lowest of all tne tax sources analyzed, highlighting the degree to which the tax is regressive.

Gasoline excise taxes.-- The gasoline excise tax is also shown to be highly regressive. This conclusion reflects the fact that gasoline consumption is a much higher percentage of low

income family budgets than of high income family budgets. The average tax rate, including both Federal and state excise taxes, is 0.74 percent. For households with incomes below $30,000, the rate is higher than average; for household incomes above $50,000 it is lower. As Table 6 shows, almost one fourth of the gasoline tax is borne by low to moderate income households and only 5 percent is borne by high income households. This regressivity is reflected in the Gini coefficient, which is -0.25.

Alcohol excise taxes.-- The distributional impact of alcohol taxes varies between beer, wine, and distilled spirits and were therefore analyzed separately in this report. All three taxes are estimated to be regressive. The gini coefficient for beer is -0.32; for wine it is -0.27; and for distilled spirits it is -0.29.

Tax Burden for the Aged and Non-Aged Population

As Table 7 highlights, excise tax burdens for the aged are somewhat higher than for the non-aged population. In the aggregate, the effective excise tax rate for the excise taxes examined in this report is 1.39 percent for the aged and 1.26 percent for the non-aged.

This result contrasts sharply with the results for the individual income tax and the social security payroll tax, which show the average effective tax rate sharply lower for the aged population.

Table 7

Effective Tax Rates of Aged and Non-Aged Population

(Percent)

	Under Age 65	Age 65 And Over	Difference
Individual Income Tax:			
Prior law	11.19	8.34	-2.85
Tax Reform Act	10.03	7.65	-2.38
Social Security Payroll Tax	4.21	1.30	-2.91
Excise Tax	1.26	1.39	+0.13

Potential Effect of Budget Resolution Revenue Increases

Both the House and the Senate have passed versions of the 1988 concurrent budget resolution that call for substantial tax increases in 1988 and subsequent years. The House version of the resolution would require tax increases of $18.0 billion in 1988. The Senate version is closely aligned with the House, recommending a tax increase of $18.3 billion in 1988 and $118 billion over the next four years.

The resolution figures cited above represent general targets for the tax writing committees. The specific tax policy changes required to achieve those targets are to be determined subsequently by the tax writing committees themselves and are therefore uncertain at this time.

Nevertheless, it does appear likely that excise taxes could be identified as a major potential source for tax increases. The Senate has already passed an accompanying "sense-of-the-Senate" resolution stating that the required tax increases were not to result from an increase in individual and corporate tax rates. Furthermore, Senate Finance Committee Chairman Bentsen has explicitly identified excise taxes, together with user fees and loophole closing measures, as initial targets for meeting the resolution revenue figures.

The federal excise taxes analyzed in this report--gasoline, tobacco, and alcohol--comprise more than three-fifths of total federal excise taxes. If excise taxes play a prominent role in achieving the resolution revenue target, the burden of these tax increases will be borne disproportionately by low income taxpayers, as the analysis in the previous section demonstrated.

Table 8 highlights this point by showing the potential effect of an $18 billion excise tax increase relative to the individual income tax reductions enacted in the Tax Reform Act of 1986. The estimates assume that the excise tax increases are distributed in proportion to the amount of federal revenues raised by gasoline, alcohol and tobacco excise taxes.

Table 8

Comparison of Enacted Income Tax Reductions and Potential Excise Tax Increases

Income Class ($000's)	Income Tax Reduction	Excise Tax Increase	Net Tax Change	Excise Tax Increase as a percent of income tax reduction
	($ Millions)			
< 10	-$414	$1,981	+$1,568	479%
10 - 20	-2,983	2,653	-329	89
subtotal	**-3,397**	**4,635**	**+1,238**	**136**
20 - 30	-3,319	2,836	-483	85
30 - 50	-8,112	5,366	-2,746	66
50 - 100	-7,609	4,324	-3,284	57
subtotal	**-19,040**	**12,526**	**-6,513**	**66**
100 - 200	-3,572	610	-2,963	17
200 >	-9,689	229	-9,460	2
subtotal	**-13,261**	**839**	**-12,423**	**6**
Total	**$-35,698**	**$18,000**	**$-17,698**	**50%**

Note: Detail may not add to total due to rounding.

Under this tax policy option, the excise tax increase for low income taxpayers greatly exceeds the tax reduction these same taxpayers recived from the Tax Reform Act of 1986. For families with incomes of less than $10,000, the excise tax increase is nearly 5 times as great as the income tax reduction. In direct contrast, for taxpayers with incomes in excess of $100,000, the excise tax increase is only 6 percent of the enacted income tax reduction.

This illustrative example assumes that the full $18 billion revenue target is achieved through excise tax increases. It therefore represents one extreme on the continuum of tax policy options that the Congress could consider. The results show, nevertheless, that excise tax burdens fall disproportionately on low income families and that any significant increase in excise taxes would more than offset any income tax reductions received by these families.

Table 9 presents estimates of the distributional effects of a $1 billion increase in excise taxes for each of the excise taxes examined in this report. This table provides a foundation for assessing the distributional effects of alternative excise tax policies.

Table 9

Distributional Impact of a $1 Billion Increase in Each Major Excise Tax

($ Millions)

Income Class ($000's)	Tobacco Excise Tax	Gasoline Excise Tax	Alcohol Excise Taxes		
			Beer	Wine	Distilled Spirits
< 10	127	99	131	104	109
10-20	161	133	159	146	164
Subtotal, Low to Moderate Income	288	232	290	250	273
20-30	174	151	165	149	153
30-50	299	307	273	298	285
50-100	202	260	225	252	241
Subtotal, Middle and Upper Middle Income	675	717	663	700	680
100-200	28	36	34	37	35
> 200	9	14	13	14	13
Subtotal, High Income	38	50	47	50	48
Total	1000	1000	1000	1000	1000

Appendix Table A-1

Income And Demographic Characteristics Of The Drinking Population

Classification	Percent of Population That Regularly Consumes Alcohol Beverages			Number of Drinks Consumed in an Average Seven Days[1/]		
	Beer	Wine	Distilled Spirits	Beer	Wine	Distilled Spirits
Age						
18 - 24	56.7	47.2	52.9	166,994	36,093	46,275
25 - 34	56.9	51.6	58.8	197,271	54,793	63,543
35 - 44	51.4	49.5	57.6	113,431	44,651	48,806
45 - 54	47.3	46.1	52.5	84,479	35,129	37,749
55 - 64	40.7	41.9	47.0	68,778	31,133	36,853
> 64	30.6	32.2	33.8	60,070	28,967	30,785
Household Income ($000's)						
< 10	40.0	30.1	36.2	114,763	26,210	31,877
10 - 15	43.0	34.6	42.3	95,368	22,418	31,708
15 - 20	48.1	40.3	49.7	63,465	16,397	23,445
20 - 25	50.5	43.4	49.8	79,990	22,913	26,359
> 25	52.6	55.4	59.9	337,436	142,828	150,621
Sex						
Male	68.9	41.7	52.5	459,511	124,998	149,952
Female	29.1	49.0	50.2	231,512	105,768	114,059

1/ The average amounts consumed in one glass of beer, wine, and distilled spirits are twelve, five, and one and a quarter ounces respectively.

Appendix Table A-2

Income and Demographic Characteristics Of The Smoking Population

(Percent)

Classification	Percentage of Population Group That Smokes	Cigarettes Smoked Per Day: Less Than 15	15-24	Greater Than 24
Male: Age				
Under 20	14.9	48.2	38.9	12.9
20-24	31.0	34.9	48.0	17.1
25-34	38.2	28.9	42.6	28.5
35-44	37.6	20.1	37.6	42.3
45-64	33.4	21.2	39.5	39.3
> 64	19.6	33.6	41.0	25.4
Female: Age				
Under 20	13.6	48.2	38.9	12.9
20-24	32.1	45.8	42.0	12.2
25-34	32.0	36.5	42.2	21.3
35-44	31.5	31.0	41.3	27.8
45-64	29.9	33.0	44.2	22.7
> 64	13.5	42.3	44.2	13.4
Household Income ($000's)				
< 7	31.1	33.4	42.9	23.7
7 - 15	33.4	30.8	53.3	15.9
15 - 25	32.2	29.9	47.7	22.4
25 - 35	30.0	21.6	46.5	32.0
35 - 50	25.2	23.7	44.4	31.9
> 50	25.2	23.7	44.4	31.9

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Mr. RANGEL. Rev. Robert McEwen.

STATEMENT OF REV. ROBERT J. McEWEN, S.J., CHAIRMAN, CONSUMERS OPPOSED TO SECRET TAXES, AND PROFESSOR OF ECONOMICS, BOSTON COLLEGE

Reverend MCEWEN. Thank you, Mr. Chairman.

My name is Robert McEwen. I am a teaching professor of economics at Boston College, and in this capacity before you today I am representing a group of consumers who have formed a coalition called Consumers Opposed to Secret Taxes.

To get to the point of this hearing, Mr. Chairman, I do thank the committee for giving us the opportunity for presenting a viewpoint allied with the consumer position on the revenue raising options faced by you in the House.

I believe, however, it would be a mistake for you to rely on excise taxes for new revenue. Congress had the good sense last year to reject excise taxes as a means of raising revenue, apparently agreeing that excise taxes are hidden taxes, a burden on the poor, a cause of inflation, and that they cost jobs.

This year, though your purpose may be different, the results will be the same. If you raise excise taxes to reduce the budget deficit, the poor will get hit the hardest, openness in government will suffer, inflation will rise, jobs will be lost, and last year's tax reform will go for naught.

To be specific, there is enough evidence before you, I think, to make the point that excise taxes are extremely regressive, they hurt those with lower incomes much more than those with more money, and as you know, a report from the Congressional Budget Office last January showed that an increase in excise taxes would be about twice as large for families in the income bracket between $10,000 to $20,000 as it would be for families making $50,000 or more. That's as a percentage of total income. So it's obvious that the burden of this tax is on those least able to afford it.

As an example of the actual costs in dollar terms, an economic consulting firm in Washington, Quick, Finan & Associates, recently did a study for us on the likely effect on the average American household of a congressional decision to raise $18 billion via excise taxes. The conclusion of the study was sobering. The average family would pay 75 percent more in excise taxes than they do now, or an additional $284 a year, on the average. That is about 3 weeks' worth of groceries for a family of four.

In fact the $284 figure is a conservative estimate of what American households would end up paying. It does not consider a number of indirect costs such as increases in State taxes and higher labor costs due to escalator clauses in union contracts, costs that are hidden in the production cost of a product.

And those excise taxes are on top of the considerable amount of excise taxes already paid by Americans, an average of $790 at the moment for Federal, State, and local levies.

The next point is that excise taxes, as is clear in most cases, are hidden, and for the most part, consumers do not know when they are being hit with an excise tax. Not many people know—as has been mentioned by members this morning—not many people know

how much they are paying in excise taxes, for example, when they fill up their car with gasoline.

Some cynics may say that Congress is thinking about new excise taxes precisely because they are hidden taxes and nobody will catch on. But I will only say this: hidden taxes go against everything that consumers have fought for in the way of open Government. We would like to know what is a tax and what is not.

We are, and have been always, in favor of truth in pricing. Excise taxes also raise inflation and cost jobs. Price rises caused by excise taxes cause some consumers to cut back on purchases. That means some companies are going to experience lower sales and loss of jobs.

In a very interesting study by the Citizens for Tax Justice, the fact becomes painfully obvious that excise taxes would erase the gains the lower and middle-income consumers received from last year's tax reform. And in this particular context, Mr. Chairman, I have read a report that the chairman of this committee is reluctant to "renege on his promise" of not tampering with the rates from last year's tax reform bill.

But I submit to you, that reneging on the tax relief granted to the lower and middle-income families is as much a renege on the promise of last year's bill as touching the rates.

And if you ask me my personal preference I would have gone on record as saying high on the list of personal preferences for revenue options would be postponing the top-bracket tax rate on the income tax for a year or two, until you made a dent in the deficit.

And I do not think that is any more of a reneging on a promise than what these excise tax increases are contemplating, which I agree with some members here, who have mentioned that that is reneging on what you promised and gave last year.

And I think that in one case it is reneging on a promise to the poor people of this country who can least afford to take that reneging. So if Congress does raise excise taxes, as has been proposed, the poor will lose twice what they gained last year from your tax reform.

Don't forget you removed 6 or 7 million people from the tax rolls, completely, and they think that that is a great benefit they got, but they are the same people who will be paying a lot of these excise taxes that are presently being proposed.

The study I mentioned before gives precise numbers to back up what I have said about the serious effect this tax has on lower and middle-income citizens, and I believe every Member of Congress has been given a copy of this study.

In a recent survey done by the International Consumer Research Institute, consumer leaders around the country were asked the following question: "If some kind of tax increase is necessary to reduce the Federal budget deficit, what kind of tax would be the fairest for consumers?"

Excise taxes came in last in that question. So today, I would like to renew our opposition, my own and our organization, and our group's, to the rise in excise taxes. We are always against any proposals to raise money secretly on the backs of the poor.

I would like to add, Mr. Chairman, from my observations of this morning's hearing, an observation that anything like the move on

excise taxes that you are contemplating now, in my view, will drive the wedge between the rich and the poor in this country farther and farther apart, and make the gap between the rich and the poor farther and farther, and wider and wider.

There was an article just the other day in the Washington Post with two facts that should not be forgotten. One mentioned that 15 years ago, the richest 1 percent of our people owned 27 percent of our wealth, whereas today, that richest 1 percent has nearly 36 percent of our wealth, which was the same percentage that the richest 1 percent had at the beginning of the Great Depression.

And the other fact is that extravagant salaries have gone through the sky. In 1981, only four corporate executives are on record as having $1 million or more in annual salary. Last year, in 1986, 220 corporate executives had over $1 million in annual salary.

And finally, on the very attractive health cost argument which has been advanced, and will be advanced, I am sure, to your committee, I am convinced that this is an avenue that you ought to resist being taken on and being pushed into.

It is true that there are health costs associated with some of the things that you are now taxing and will be asked to tax, and as time goes on there will be nothing that you cannot attach a social cost or a health cost to, and I have facetiously suggested that you really ought to consider the fact that obesity in this country presents a great health problem, and therefore, you maybe ought to start taxing candy and chocolates.

Finally, on the question of taxation use as a social behavior modification vehicle, I think that is another area that you should resist. It is not, in my judgment, true, that the high price of drugs these days has curtailed the use of them, and I do not think, as some witnesses have mentioned here before, that the high price of any of these other items that you intend to tax, is going to succeed in curtailing the abuse or the extravagant use.

So I recommend that you go along the lines you started a few years ago in the Excise Tax Reduction Act, and you return to that exercise. I think you are contributing, every time you pick up one of these ideas, you are contributing to the complexities, the confusion in the public, the resentment in the public, and the enormous incentives to evasion that you have heard about already.

I just think this excise tax vehicle is the wrong way for you to go, and I would ask you, instead of amplifying the excise tax, get rid of them as fast as you can and you will be doing the public a favor.

Thank you, Mr. Chairman.

Mr. RANGEL. Thank you, Reverend. Dr. Denman Scott, American College of Physicians.

STATEMENT OF H. DENMAN SCOTT, M.D., FACP, MEMBER, BOARD OF GOVERNORS, THE AMERICAN COLLEGE OF PHYSICIANS, DIRECTOR OF HEALTH, STATE OF RHODE ISLAND, AND CLINICAL ASSOCIATE PROFESSOR OF MEDICINE, BROWN UNIVERSITY

Dr. SCOTT. Thank you, Mr. Chairman. I am Denman Scott, a member of the board of governors of the American College of Phy-

sicians. I am also director of health for the State of Rhode Island, and clinical associate professor of medicine at Brown University.

I should add, too, that I am on the executive committee of the Association of State and Territorial Health Officials, and the position I shall espouse today is identical to the position of the State health officers of this country.

The American College of Physicians represents over 65,000 doctors of internal medicine, subspecialists such as cardiologists and gastroenterologists, and physicians-in-training.

During the past 6 or 7 years, programs providing health care for meeting the basic needs of the poor or the elderly, children and veterans, and others, have been curtailed in an effort to reduce the Federal deficit.

Billions of dollars have been taken out of Medicare and other health programs, and again, this year, your committee is charged with cutting Medicare spending by $9 billion over the next 3 years.

You have the opportunity, now, to endorse a deficit-reduction measure that raises $3 billion in revenue in fiscal year 1988, and, at the same time, contributes positively to the health of our citizens. The medical effects of smoking are devastating; 350,000 Americans die prematurely each year because of illnesses caused by the cigarette. It also shortens a person's lifespan on the order of from 5 to 8 years.

Indeed, most of the consequences of smoking are suffered prior to the age of 65. Cigarette smoking accounts fully for 30 percent of the more than 400,000 cancer deaths annually occurring in the United States. Heavy smokers, you should know, are three to four times more likely to die of cancer than nonsmokers, and 15 to 25 times more likely to die of lung cancer than nonsmokers.

Lung cancer has now exceeded breast cancer as the leading cause of cancer death among women. Cigarette smoking is a major cause of coronary heart disease and contributes to 30 percent of all heart attack deaths in the country.

Cigarettes cause chronic obstructive pulmonary disease, emphysema, and bronchitis. Women who smoke commonly have low birth-weight infants who often have associated developmental disability. Finally, smoking is a major cause of fires in the United States, and some 4,000 injuries and 1,500 deaths a year occur as a result of smoking-fire accidents.

It is indisputable, Mr. Chairman, that smoking causes chronic disease and kills many people. Moreover, the cost of cigarette related disease and death is enormous. The direct medical costs of smoking-related disease are in excess of $23 billion, annually.

The Office of Technology Assessment has estimated that of the total medical bill for smoking, the Federal Government paid $4.2 billion in 1985 through Medicare, Medicaid, and other health programs. This is about 14 cents for each pack of cigarettes sold.

It seems to me that the committee would be justified in adopting the 16 cent increase, if for no other reason than simply to pay for the cost of this care. What would be the impact of the tax on smoking behavior? And this is a crucial point.

The higher the cost of a pack of cigarettes, the more people will decide to quit smoking or not start. If Congress increases the excise

tax by 16 cents, very solid economic analysis shows that upwards of 3.5 million Americans would decide to quit or not start.

Of these, more than 820,000 are teenagers, 12 to 19, and almost 2 million are young adults in the 20- to 30-year age category. Now I would note that everybody is worried about the regressivity of this tax, but if you stop, you stop paying the tax. Again I want to emphasize the impact on teenagers.

Good studies show that the 16-cent tax increase would result in a 21-percent decrease in consumption among these young people. In conclusion, Mr. Chairman, these figures are dramatic. By increasing the cigarette tax by 16 cents a pack, this important means of deficit reduction has the coincidental benefit of reduced death and disability, and, over the long-haul, reduced health-care expenditures.

Thank you very much.

[The statement of Dr. Scott follows:]

STATEMENT
of the
AMERICAN COLLEGE OF PHYSICIANS
before the
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
July 9, 1987

The American College of Physicians (ACP) is pleased to have this opportunity to appear before you today to present our views on proposed increases in federal revenues. I am H. Denman Scott, M.D., FACP, a member of the Board of Governors of the College. I am also Director of Health for the State of Rhode Island, and Clinical Associate Professor of Medicine at Brown University.

The American College of Physicians represents over 65,000 doctors of internal medicine, subspecialists, and physicians-in-training. Our membership includes private practitioners delivering primary health care; medical specialists in such fields as gastroenterology, endocrinology, oncology, and cardiology; medical educators; and researchers. Since its inception in 1915, the College has sought to uphold high standards in medical education, medical practice, and research.

Overview

Mr. Chairman, normally when the ACP appears before your Committee or other committees, we address issues of spending for Medicare, Medicaid, and other public health programs, or we address other legislative or regulatory issues related to public health policy and the practice of medicine. We usually defer to other experts on questions of federal revenue. However, you will be considering a revenue issue with the potential for having a direct and dramatic impact on the health status of Americans, so the College felt compelled to request the opportunity to testify today. I am speaking, of course, of the proposal to increase the excise tax on cigarettes.

During the past six or seven years, programs providing health care and meeting the basic needs of the poor, the elderly, children, veterans, and others have been curtailed in an effort to reduce the federal deficit. Billions of dollars have been taken out of Medicare and other health programs, and again this year, your Committee is charged with cutting Medicare spending by $9 billion over the next three years.

You have the opportunity now to endorse a deficit reduction measure that raises a significant amount of revenue and at the same time contributes positively to the health of our citizens. Not only will a 16-cent cigarette tax increase reduce the deficit by adding some $3 billion in revenue in FY 88 (and $15 billion over a five-year period), but it can also reduce the deficit in the best way possible -- by preventing serious illness that drains the federal budget for Medicare and Medicaid. Mr. Chairman, the American College of Physicians urges you to include the 16-cent per pack increase in your deficit reduction package.

The Medical Effects of Smoking

Beginning after World War I, cigarette-induced disease represents the worst disease epidemic in our history. The weight of the medical evidence is overpowering. I would like only to summarize the salient facts:

(1) 350,000 Americans die prematurely each year because of illnesses caused by cigarette abuse. This is more than the combined total of annual deaths resulting from automobile accidents, alcoholism, drug abuse, and AIDS. More Americans have died in this century from cigarette-caused lung cancer than have been killed in our wars.

(2) Cigarette smoking accounts for 30 percent of the more than 400,000 cancer deaths annually in the United States. Eighty-five percent of all lung cancer in the U. S. is due to cigarettes. Cigarettes are also important in the causation of oral, laryngeal, esophageal and bladder malignancies.

(3) Heavy smokers are 3-4 times more likely to die of cancer than are non-smokers. They are 15-25 times more likely to die of lung cancer than non-smokers. Lung cancer deaths in women have increased so fast in the past 20 years that lung cancer has now exceeded breast cancer as the leading cause of cancer death among women.

(4) Cigarette smoking is a major cause of coronary heart disease. One half million Americans died of coronary heart disease last year, and about 30 percent of these deaths can be attributed to cigarette smoking.

(5) Cigarettes are the main cause of chronic obstructive pulmonary disease. Some 9 million people, or 80-90 percent of all cases, suffer from chronic bronchitis and emphysema caused by smoking. More than 60,000 of these patients die each year.

(6) Women who smoke during pregnancy can damage the fetus. Studies show that smoking mothers tend to deliver lower birth weight babies and have higher miscarriage rates. Infants born to smoking mothers experience higher neonatal death rates.

(7) Smoking is a major cause of fires in the United States. Approximately one-third of all apartment, hotel, and motel fires, and 17 percent of private dwelling fires, are attributable to smoking. These result in 4,000 injuries and 1,500 deaths annually.

It is indisputable, Mr. Chairman, that smoking causes chronic disease and smoking kills. It is the only consumer product that, when used as intended, is harmful to human health.

The Cost of Cigarette-Related Disease and Death

In addition to the cost in human terms, the financial cost associated with this epidemic is staggering, and of direct relevance to the deficit in terms of public expenditures for health care and lost income tax revenue from individuals whose working lives have been cut short by disease or death.

The direct medical costs of smoking-related disease are in excess of $23 billion annually, according to a recent study by current and former officials of the National Center for Health Statistics. This amounts to about 72 cents for each pack of cigarettes sold in the U.S.

The Office of Technology Assessment has estimated that, of the total medical bill for smoking, the federal government paid about $4.2 billion in 1985 through Medicare, Medicaid, and other health programs. This is about 14 cents for each pack of cigarettes sold. Mr. Chairman, it seems to me that the Committee would be justified in adopting the 16-cent increase if for no other reason than simply to pay for the cost of this care.

The study I referred to earlier estimated that salary losses attributable to smoking-related diseases total more than $9 billion. Premature deaths due to smoking account for some 3.9 million person-years lost, with life-time earnings losses amounting to more than $21 billion. Other studies show estimates even higher than these.

The point is not to pin down the exact cost of smoking-related disease and deaths. Estimates vary, but they are all in the tens of billions of dollars. The key point is that federal health care expenditures, income tax losses, and other costs of smoking are a drain on the federal budget and the economy as a whole, and this committee can take a step to reduce that loss.

Impact of a Tax Increase on Smoking

The higher the cost of a pack of cigarettes, the more people will decide to quit smoking or not to start. If Congress increases the excise tax by 16 cents, econometric analysis shows that upwards of 3.5 million Americans would decide to quit or not to start smoking.

A number of economists have studied the price elasticity of demand for cigarettes -- that is, the responsiveness of demand to changes in price. In one of the more conservative analyses, Lewit *et al.* have shown

that a 10 percent increase in price reduces the quantity of cigarettes demanded by 4.2 percent for adults (age 20-74). Most importantly, they find that demand would decrease by 14 percent for teenagers aged 12-17, and by 8.9 percent for young adults in the 20-25 age group.

Dr. Kenneth Warner has applied these findings to project the smoking reduction that would result from an excise tax increase. He finds that a 16-cent per pack increase would encourage 3.5 million individuals to quit or not to start smoking. Of these, more than 820,000 are teenagers (12-19), and almost 2,000,000 are young adults aged 20-35.

Dr. Warner calculates that the 16-cent increase would result in 36 billion fewer cigarettes smoked, or about 6 percent of the 600 billion cigarettes smoked annually in this country.

Again, I want to emphasize the impact on teenagers. Dr. Warner shows that the 16-cent tax increase would result in a 21 percent decrease in consumption in the 12-17 age group. This compares to a 6.3 percent decrease for all adults. The potential for having this kind of impact on teenagers is critical when you realize that very few people start smoking when they are past 21.

Finally, and to bring this back to where we started, what would be the health effects of a tax-induced decrease in smoking? We know that one out of every four lifelong smokers dies of a smoking-related illness. Based on Dr. Warner's projection that a 16-cent increase would cause 3.5 million people to quit or not start smoking, then one-fourth of these, or more than 860,000 people, would be saved from premature death.

Conclusion

Mr. Chairman, these figures are dramatic. By increasing the cigarette tax by 16 cents a pack, not only can you raise a substantial amount of revenue, but you also have the potential of saving hundreds of thousands of lives and billions of dollars in medical costs and lost productivity.

The medical facts about smoking are compelling. The economic impact of smoking-related disease and death is enormous. But you have, if I may use the term, a magic bullet. An excise tax increase can help to reduce the deficit and can have a major impact on smoking. It will not solve the whole problem, but together with the continuing efforts of physicians and others to educate people and help them change their habits, it can begin to contain the epidemic. Mr. Chairman, the American College of Physicians urges Congress to adopt a cigarette excise tax increase this year.

Mr. RANGEL. Thank you, Doctor. Doctor, are there any other legislation initiatives that the College of Physicians are supporting to stop smoking?

Dr. SCOTT. Not that I am aware of.

Mr. RANGEL. Well, why not? I mean, if this thing is as dangerous as you say it is—and I have every reason to believe that it is—why don't you advocate banning subsidies to tobacco farmers or outlawing the distribution of cigarettes, or just saying, like Mrs. Reagan, just say no?

Dr. SCOTT. Well, I think that one of our first jobs is to educate the public about the enormous consequence of smoking, and people do not appreciate the impact of the cigarette in our society.

Mr. RANGEL. Doctor, this is not an educational program that you are testifying to.

Dr. SCOTT. No, I know it is a tax program.

Mr. RANGEL. This is tax. So what I am asking is that why don't doctors say that cigarettes are so dangerous that it is a threat to our national security and Americans should ban them from showcases in stores, and all of that? I mean, you talk about all the people who are going to stop smoking.

Have you got any idea as to what income bracket those people are in, that are going to stop smoking?

Dr. SCOTT. Well, I think most of the impact will occur among the young. In other words, the middle-aged smoker——

Mr. RANGEL. Now I did not ask you about the age——

Dr. SCOTT. No, no, but I am getting to the income bracket, and that is that the young have a high concentration of poverty people, and the economic analysis suggests that among the poor, that the excise-tax increase will have a more powerful impact on the quitting behavior, or the hesitancy to start in the first place.

Mr. RANGEL. So it discriminates against the wealthy and the more affluent because they will not have a deterrent to stop smoking?

Dr. SCOTT. It will not be the same deterrent. However, there, the educational initiatives tend to be more potent.

Mr. RANGEL. So this is really a program designed to assist the poor?

Dr. SCOTT. I think it could be construed as that, that the impact will certainly be most heavily felt among young poor.

Mr. RANGEL. Well, there are other programs that you might want to take to the College of Physicians, in the Medicaid and Medicare programs, that might help the poor, too, and I would like to see the college focus some attention on them.

Dr. SCOTT. We will take that, we will consider that, Mr. Chairman.

Mr. RANGEL. If you have anything coming out of the college that concerns the poor, and to give them assistance besides increasing the taxes on them. I assume you support the increase in taxes on beer since that is not very helpful to their health?

Dr. SCOTT. We debated whether we should come in with supporting both those excise taxes, and, frankly, if you had to choose we would take cigarettes first because that is the most measurable impact and the most dangerous public-health threat, not that alcohol is not a problem.

We would not object to raising taxes on beer, either.

Mr. RANGEL. How about greasy foods and high-caloric foods?

Dr. SCOTT. Well, I will take cigarettes first, alcohol second, and I would defer comment on that for now, although I would certainly counsel people to be cautious about fatty food intake. [Laughter.]

Mr. RANGEL. Well, if you could provide a list of where the tax system could be used to encourage better health habits, then maybe we can just take a whole package of taxes and see whether or not we can make these poor folks a lot more healthy. I am reluctant to do it, but since you come from a College of Physicians that have given this more study than I have, maybe we can just get a whole list of things that poor folks just do to survive that are unhealthy, and instead of education, since your statistics show that they obviously do not respond too well to educational devices, we just will tax them until they learn to do the right thing, at least according to the medical codes that are set up.

And I assume you have some type of program for doctors that smoke because——

Dr. SCOTT. May I speak to that?

Mr. RANGEL. Surely.

Dr. SCOTT. Well, you see, the doctors have seen the consequences of smoking over the past 30 or 40 years, and we have done regular surveys in my home State of Rhode Island, and have noted that doctors smoked as commonly as the general population in 1964, 35 to 40 percent smoked. Now less than 8 percent smoke.

And among young physicians, it is less than 5 percent. Physicians have the message because they see the impact. We are anxious to use whatever device, through tax policy, through education, whatever means we can come up with, to make it clear to the American public the hazards here.

It is quite coincidental that we are here talking before a tax panel, but it is quite clear from the study that such a tax, because we have been able to watch what has happened with the change in excise tax over the past few years, the behavior of the people change and less smoking occurs among those we would like to see smoke the less, among the young.

Mr. RANGEL. Do you have an antidrug program, anticocaine, heroin?

Dr. SCOTT. We do not have a tax policy on that. You have had the excise tax, and their proposal to raise it, and we like it because it has a health benefit.

Mr. RANGEL. So you believe that the way to get at these serious addiction problems of cigarettes and drugs is by using the Tax Code?

Dr. SCOTT. I think that we have seen that the data shows that behavior changes in response to tax policy, and insofar as the cigarette problem is as big as it is, we think it is reasonable to support it because of its health utility.

Mr. RANGEL. Well, we have a tax on the import of narcotics but it has not been too effective in terms of administering it, but do you have an educational program as relates to drugs among the poor and the impact that it has?

Or the spreading of AIDS, and children that are born addicted to drugs? Would the American College of Physicians be involved in

these programs that have affected the poor more than other economic groups?

Dr. SCOTT. Yes, indeed. The college has positions on these in support of a variety of efforts to deal with those problems, but not in the context of tax policy.

Mr. RANGEL. Oh, you just deal with the health problems that we can deal with from taxes?

Dr. SCOTT. Well, let me say this, Mr. Chairman. The reason we are here is, basically, that we have seen quite clearly the impact of the excise taxes on smoking behavior.

The committee ought to be aware of that. The physicians of the American College are anxious to espouse anything that will help the American people smoke less, and you should know those facts as you deliberate on how to deal with the deficit reduction.

We are very narrowly focused here and I am not trying to come up with a whole tax policy that would manipulate the health behavior of the country. We have done a national experiment which has illustrated the impact of excise taxes on smoking behavior.

Mr. RANGEL. I thought I understood you to say, Doctor, that this will have the strongest impact on the poor, but that for older people and more affluent people, they respond to educational programs a lot more than the poor groups, and I am saying if that is so for cigarettes—and I am not arguing with you—I assume that you are involved in these educational programs and you are not restricting yourself to tax policy.

Dr. SCOTT. Absolutely true.

Mr. RANGEL. That is what I thought. And then I was asking you what programs do you have that are not related to taxing narcotics, which obviously would not work, that would serve to educate and prevent poor people, and others, from abusing drugs?

Dr. SCOTT. Well, we have a variety of educational programs for the college membership. We have a journal which discusses how to manage drug-addiction problems. We relate to sister-collegial groups that are interested in the drug-abuse problem and are very sensitive to this.

I mean, really, there are many, many programs of the college which I would be glad to discuss.

Mr. RANGEL. Well, I certainly want you to know, Doctor, that the record will be kept open for you to share with us the work that you are doing in the other areas to assist the poor in trying to maintain good health standards.

David Gardiner of the Sierra Club.

STATEMENT OF DAVID GARDINER, LEGISLATIVE DIRECTOR, THE SIERRA CLUB

Mr. GARDINER. Thank you, Mr. Chairman. I am David Gardiner. I am the Sierra Club's legislative director, and I am here today on behalf of the 410,000 members of the Sierra Club across the country.

We appreciate the chance to be here. I am here today to offer the Sierra Club's support and to urge the committee to adopt two tax proposals which will improve the health of all Americans, young, old, rich, poor, all across the country, and those are proposals to

tax three air pollutants—sulfur dioxide, nitrogen oxide, and chlorofluorocarbons, or CFC's, as they are more commonly known.

The Sierra Club supports the legislation which has been introduced by Congressman Gregg, Congressman Frenzel, and Congressman Downey, to tax sulfur dioxide and nitrogen oxide emissions, as well as the legislation that has been introduced by Congressman Stark to tax CFCs which are responsible for the destruction of the Earth's ozone layer.

It is very clear today, that the American public is paying a very high price in terms of its own health, for its exposure to these pollutants and for the damage which they are causing to our environment.

This is also, unlike cigarette smoking or alcohol, it is not a choice. We have all got to breathe, we have all got to go outside in the sunlight, and as we breathe, or as we are exposed to the cancer-causing ultraviolet rays of the sun, we are experiencing the health damage which these pollutants cause.

Let me focus, first, on the proposal to tax sulfur and nitrogen oxides. These chemicals are real killers. They are the prime components of acid rain. Health experts now tell us that acid rain is the third leading cause of lung disease in this country trailing only active and passive smoking.

The American Lung Association estimates that—and I am sorry it is incorrectly stated in my written testimony here—that sulfur dioxide, nitrogen oxides, and sulfates, which are a chemical derivative of sulfur dioxide, alone, cost the American public $16 billion a year in damages. Those are costs of increased hospital visits, lost time at work, and those other kinds of things.

The Congressional Office of Technology Assessment estimates that sulfate pollution—again, a derivative of sulfur dioxide—causes approximately 50,000 premature deaths each year in this country.

Researchers in Canada have now clearly documented increased hospital visits during periods of elevated sulfur dioxide pollution. Nitrogen oxides, on their own, are also a prime component of urban smog, the nation's most pervasive air-pollution problem, and more than 100 million Americans still breathe unhealthy levels of urban smog, and will continue to do so until these emissions of nitrogen oxides and other pollutants are reduced.

These areas of the country in which people breathe unhealthy levels of urban smog include virtually the entire eastern seaboard, everything from Chicago eastward, to Boston and Maine. Virtually everything from Houston to Baton Rouge, and obviously, many parts of California as well.

The Gregg-Downey legislation would tax these chemicals with the dirtiest polluters paying the highest tax of 45 cents per pound, and there would be corresponding reductions in the emissions of these as the polluting facilities would have an incentive to clean up these emissions.

If anything, the tax rates that are proposed in the Gregg-Downey legislation are too low. There are estimates from the industry that would justify a tax level that would be twice as high as that proposed at the highest rate of the ascending scale under the Gregg legislation, so the committee could easily consider increasing the rate that has been proposed by Congressman Gregg, and others.

I wanted to focus particularly on one concern that was raised by the staff of the Joint Committee on Taxation, and that has to do with trade, and I know that is an important concern for this committee and for the Congress.

The staff suggested that it may be more difficult for domestic producers to compete in the international marketplace because of the increased price of domestic manufacturing as a result of the increased price of electricity, but it should be noted that the United States is virtually alone in the industrialized world in failing to control the pollution which causes acid rain.

If we are maintaining a trade advantage today through lower manufacturing costs, it is only by forcing the American public to pay the price of breathing unhealthy air, and damage to the environment from acid rain. Moreover, our competitors in the international trade market are already investing in pollution control.

Canada has adopted a program to reduce its sulfur dioxide emissions by 50 percent by the year 1994. West Germany, one of our fiercest competitors in the international trade market, will, by the end of the year, install scrubbers on every coal-fired powerplant in the country.

Most other industrialized nations have already signed an international pledge to reduce emissions of sulfur dioxide by at least 30 percent by 1993. Thirty percent is approximately the level of reduction that might be anticipated under the Gregg-Downey legislation.

The countries that have pledged to make a 30 percent reduction include Canada, West Germany, France, Sweden, Norway, Denmark, Finland, the Netherlands, Austria, Switzerland, Belgium, Luxembourg, Lichtenstein, East Germany, the Soviet Union, and Bulgaria.

I want to turn now to the issue of chlorofluorocarbons or CFCs, the chemicals which are responsible for the rapid depletion of the Earth's ozone layer.

There is a wide consensus in the scientific community that these gases are destroying the stratospheric ozone layer which protects the Earth from the Sun's harmful ultraviolet rays, and the Environmental Protection Agency forecasts an incredible array of health and environmental damages if the ozone layer continues to deplete at its present rate.

If CFC emissions continue to grow and ozone depletion continues as well, we can expect, according to the Environmental Protection Agency, over the next 80 years, an additional 800,000 deaths, 40 million cases of skin cancer, and 12 million cataracts.

The scientific findings are so compelling that even the industrial groups have changed their position to support limits on CFC production. Du Pont, the world's largest producer of CFC advocates cuts in current CFC emission levels, while the industrywide trade group, the Alliance for Responsible CFC Policy supports a slowdown in emissions growth.

In summary, I would just like to say that we urge the committee to adopt both of these tax proposals. It is time to make the polluters and not the American public pay the price for air pollution.

[The statement of Mr. Gardiner follows:]

SIERRA CLUB

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STATEMENT OF DAVID GARDINER

LEGISLATIVE DIRECTOR FOR THE SIERRA CLUB

ON BEHALF OF THE SIERRA CLUB

REGARDING H.R. 2497 AND H.R. 2854:

LEGISLATION TO TAX SULFUR DIOXIDE, NITROGEN OXIDES

AND CHLOROFLUOROCARBONS

BEFORE

THE HOUSE WAYS AND MEANS COMMITTEE

HONORABLE DAN ROSTENKOWSKI, CHAIRMAN

JULY 9, 1987

My name is David Gardiner, Legislative Director for the Sierra Club, an environmental organization with 410,000 members nationwide. The Sierra Club thanks the Committee for the opportunity to testify today.

My testimony today focuses on the two major pollution tax proposals before the Committee for consideration: H.R. 2497, the Gregg-Downey proposal to tax sulfur dioxide and nitrogen oxide emissions, and H.R. 2854, Representative Stark's proposal to tax chlorofluorcarbons (CFCs). The Sierra Club strongly supports both of these pollution tax proposals. They will make an important step in ending the chemical warfare which the polluters are waging on the health and safety of all Americans. It's time to make the polluters pay for pollution, not the American public. And while neither of these proposals is a complete substitute for a regulatory program to reduce these pollutants, they will provide measurable environmental benefits while raising additional revenues to shrink the federal deficit.

TAXING SULFUR DIOXIDE AND NITROGEN OXIDES

The American public is paying a massive price for the 50 million tons of sulfur and nitrogen oxides which polluters shoot into our atmosphere each year. Indeed, health experts have labeled acid

rain the third leading cause of lung disease in this country, trailing only active and passive cigarette smoking. The American Lung Association now estimates that sulfur dioxide alone causes at least $16 billion in damages to the American public each year.

Sulfur dioxide and nitrogen oxides aggravate human respiratory illnesses. Small particles of these pollutants can lodge deep within the lungs and cause bronchial irritation and breathing problems. Senior citizens, children, pregant women, as well as those with existing lung or heart problems are particularly at risk.

The Congressional Office of Technology Assessment (OTA) determined that airborne sulfate pollution -- a derivative of sulfur dioxide -- causes approximately 50,000 premature deaths each year. Researchers in Canada have now clearly documented increased hospital visits during periods of elevated sulfur dioxide pollution.

Nitrogen oxides are also a prime component of ozone or "smog" -- the nation's most pervasive air pollution problem. More than 100 million Americans still breath unhealthy levels of urban smog and will continue to do so until emissions of nitrogen oxides and other pollutants are reduced.

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In study after study, sulfur dioxide and nitrogen oxides have been fingered as the cause of acid rain which is wreaking widespread damage across the North American continent. While damage from acid rain is well-documented in the Northeast and upper Midwest, acid rain damage is now found in virtually every region of the country. Here are just a few examples:

* Florida has 677 acidified lakes, more than any other state in the country. Rainfall in the state is ten times more acidic than normal.

* Acid rain causes $272 million in damages to buildings and statues in Illinois.

* Rainfall in Texas is ten times as acidic as normal, and now threatens the state's timber resources in the eastern part of the state.

* Acid fog in California has been measured at pH of 1.7 or more than 8,000 times more acidic than normal rainfall.

* In Colorado, acidity of rainfall has increased substantially and particularly threatens high altitude lakes in the Rockies.

The Gregg-Downey legislation would tax these deadly chemicals, with the dirtiest polluters paying the highest tax of $.45 per pound. Operators of these polluting facilities would have an incentive to clean up these emissions. According to studies done by the Congressional Budget Office and the Office of Technology Assessment, it would be reasonable to anticipate reductions of between six and ten million tons in sulfur dioxide, provided that utilities are not able to simple pass on the costs of this new excise tax to their ratepayers.

If anything, the tax rates proposed in the bill are too low. According to the utility industry, the costs of pollution reductions under an acid rain control program of similar magnitude are approximately the costs assumed in the Congressional Budget Office study supporting the Gregg-Downey proposal. The Committee could easily consider doubling the rate charged under the Gregg-Downey bill for both sulfur dioxide and nitrogen oxides. Based on the industry estimates, this would produce the same level of pollution reductions called for under other regulatory-style acid rain bills, but would generate twice as much revenue.

In its discussion of the this proposal, the staff of the Joint Committee on Taxation raised three possible arguments against it. They said that it could:

* raise domestic manufacturing costs, making it more difficult for U.S. producers to compete in international and domestic markets;

* require costly monitoring of emissions or fuel content to calculate tax payments;

* discourage the use of high sulfur coal, adversely affecting the high-sulfur coal industry of the Midwest and Appalachia.

First, while it is true that the costs of domestic manufacturing might be raised by the imposition of this tax, it should not be more difficult for domestic producers to compete in the international marketplace. The United States is virtually alone in the industrialized world in failing to control the pollution which causes acid rain. If we are maintaining a trade advantage today through lower manufacturing costs, it is only by forcing the American public to pay the price of breathing unhealthy air and damage from acid rain.

Moroever, our competitors in the international trade market are already investing in pollution control. Canada has adopted a program to reduce its sulfur dioxide emissions by 50% by the year 1994. West Germany, one of our fiercest competitors in the international trade market, will by the end of this year install

scrubbers on every coal-fired power plant in the country. Most other industrialized nations have already signed an international pledge to reduce emissions of sulfur dioxide by at least 30% by 1993, including: Canada, West Germany, France, Sweden, Norway, Denmark, Finland, the Netherlands, Austria, Switzerland, Belgium, Luxembourg and Liechtenstein, East Germany, the Soviet Union, and Bulgaria.

Second, according to the Congressional Budget Office Study of pollution tax systems, the administrative costs for taxpayers for this program should be small. All of these facilities must presently file similar information with various government agencies responsible for air pollution control. It is simply a matter of converting this information for use by the Internal Revenue Service.

Finally, a simple bill to tax emissions of sulfur dioxide and nitrogen oxides will raise the price of fuels with high content of these pollutants and discourage their use. But the Joint Committee staff fail to point out that this will also create a corresponding incentive to increase the use of fuels with lower sulfur and nitrogen contents, such as low sulfur coal, oil, and natural gas.

A sulfur and nitrogen oxide tax proposal could easily be structured to offer greater protection to the high sulfur coal

industry. Indeed, both Representatives Gregg and Downey joined the Sierra Club several years ago in supporting an acid rain control proposal which would have protected the high-sulfur coal industry. Unfortunately, the bill was killed in large part by the lobbying of the group that would have benefited most under the proposal -- the high sulfur coal industry.

TAXING CHLOROFLOUROCARBONS

The Sierra Club also supports the proposal by Representative Stark to tax chloroflourocarbons and other chemicals responsible for the rapid depletion of the Earth's ozone layer. There is wide consensus in the scientific community that these gases are destroying the stratospheric ozone layer which protects the Earth from the Sun's harmful ultraviolet rays.

These chemicals are used in a wide array of commercial and industrial applications, including refrigeration,, insulation, aerosol propellants, solvents, styrofoam packaging and fire extinguishers. At lower altitudes, these chemcials contribute to global warming, while at higher altititudes, the chlorine and bromine compounds catalyze a chain reaction in which ozone is destroyed, increasing the planet's exposure to cancer-causing ultraviolet rays.

The Environmental Protection Agency forecasts an incredible array of health and environmental damages, if the ozone layer continues to deplete at its present rate. If CFC emission continue to grow, an additional 800,000 deaths, 40 million cases of skin cancer, and 12 million cataracts can be expected over the next 80 years.

The current scientific findings are so compelling that even industrial groups have changed their positions to support limits on CFC production. Dupont, the world's largest producer of CFCs, advocates cuts in current CFC emission levels, while the industry-wide trade group, the Alliance for Responsible CFC Policy, supports a slowdown in emissions growth.

The sliding scale of taxes proposed in Representative Stark's legislation is reasonable, as it will allow the producers of CFCs to explore alternative chemicals which may be less harmful to the Earth's atmosphere.

The Sierra Club strongly urges the Ways and Means Committee and the House of Representatives to adopt both of the pollution taxes. We look forward to working with you to help accomplish your goal of increasing federal revenues, while providing substantial benefits to society.

Mr. RANGEL. Thank you. Miss Susan Buffone, executive director, National Clean Air Coalition.

STATEMENT OF SUSAN M. BUFFONE, EXECUTIVE DIRECTOR, NATIONAL CLEAN AIR COALITION

Ms. BUFFONE. Mr. Chairman, and members of the committee, my name is Susan Buffone. I am speaking today as the executive director of the National Clean Air Coalition, representing more than two dozen national environmental, public health, labor and public-interest organizations, and millions of Americans concerned with clean air.

The coalition appreciates this opportunity to go on record in support of a national program to tax sulfur and nitrogen oxide emissions, and emissions of chlorofluorocarbons. These pollutants are causing grave damage to the human and natural environment. The Nation has an enormous financial and fiscal stake in their reduction. Given the apparent difficulty in addressing a reduction program in other forms, the Congress and the country would owe you a debt of gratitude if you enact these provisions.

The National Clean Air Coalition believes a tax on CFC's is a useful tool in the context of an overall reduction and eventual phaseout of these long-lived destroyers of the Earth's protective ozone layer. The coalition wishes to thank Congressman Stark for his leadership on this issue.

His actions stand in sharp contrast to Interior Secretary Hodel's efforts to trivialize this issue. Since others today have addressed the CFC proposal in detail, I will confine the balance of my statement to the proposed tax on sulfur and nitrogen oxide emissions.

It is based on legislation sponsored by Congressmen Gregg, Downey, and Frenzel. We wish to commend them for their effort to move forward on an acid-rain control program despite the apparent stalemate in other House forums.

These pollutants are a major health and environmental concern in America today. They are so common and so dangerous to humans, that direct exposure is regulated through national ambient air-quality standards designed to protect human health with an adequate margin of safety.

And they are the principal precursors of acid deposition or acid rain, a long-term pollution problem whose symptoms include dead and dying species of plants, animals, and fish, reduced forest growth, damage to buildings, monuments, structures, and other parts of the human environment, and secondary health effects as aluminum and other metals are leeched into water systems.

Mr. Chairman, a spokesman for the American Lung Association has called sulfur pollution the third leading cause of lung disease after active and passive smoking. A recent Harvard University study estimated that the combined effects of particulate and sulfate pollution caused perhaps five percent of all deaths in the average polluted urban area.

Earlier studies have estimated that sulfates are a major factor in 50,000 premature deaths in Northeastern North America each year. These studies are so frightening in their implications, Mr.

Chairman, that supporters of clean-air legislation hesitate to cite them for fear they are beyond belief.

Admittedly, the evidence is not direct but statistical, but the evidence is mounting that the Federal response to sulfur and nitrogen oxide control has been tardy and inadequate. The proposal before you to tax sulfur and nitrogen oxide emissions at 45 cents is one way to improve the Federal response. It is by no means the only way.

My colleagues in the environmental community are also testifying this morning in the Energy and Commerce Committee in support of a more detailed response, that we also support, and that many would prefer.

But studies by the Congressional Budget Office, and others, suggest the approach you are considering would accomplish the fundamental goal of any clean-air program. It would reduce the pollutants of concern and it would get results quickly. Beyond that, it would give the polluters their choice of control based on their own economic, engineering, and geographic circumstances, a policy goal of many supporters of acid-rain legislation.

Today it is the American people who are bearing the cost of excess sulfur and nitrogen oxide pollution. The National Academy of Sciences estimate resource damage from acid rain amounts to $7 billion per year, an estimate that is almost certainly low.

The American Lung Association surveyed recent cost studies, and concluded that the health consequences of air pollution cause, perhaps, $40 billion per year in health care and lost productivity. The American taxpayer directly bears a portion of that cost in Medicare and Medicaid payments.

Let me conclude by touching, briefly, on five counterarguments you may hear.

Argument 1: a tax is an inappropriate response to the problem. We say, in the first place, sulfur and nitrogen oxide emissions are a perfectly appropriate source of revenue. Emissions taxes are used around the world. In the second place, the Tax Code is often used to further the social as well as economic interests of the country.

Argument 2: this problem should be addressed comprehensively. We respond, let those who make that argument come forward with their program ideas. The National Clean Air Coalition supports pollution reduction on a rapid schedule. These taxes are but one approach. Other approaches that more completely address the competing economic forces in the energy industry are also acceptable to us. Indeed, we have aggressively advocated acid-rain legislation since 1981, without a single appearance before this committee. We are continuing to work on a programmatic response.

Third, the energy industry is complicated and continuous emission monitoring would be required. Thus, the tax would be hard to administer. The Congressional Budget Office has pointed out, in 1986, that the utility industry is relatively uniform. Developing formula estimates would be straightforward, and the administrative costs of the tax would be small relative to revenues collected. In addition, many plants already monitor their emissions on a continuous basis, or are already required to do so. Many more will soon do so as well.

Fourth, the tax would put domestic manufacturers at a competitive disadvantage since energy costs would increase. Studies of energy use, however, show energy represents a tiny portion of cost for virtually all manufacturing categories. Industries with relatively high energy use would have a stake in encouraging emission reductions, and in pursuing energy conservation programs that make sense for many other reasons.

And five, the tax discriminates against high-sulfur coal use. There are many ways to fashion a program that would virtually guarantee that mining employment in high-sulfur areas remain stable as a reduction program is put into place, and there are technological alternatives in use today and coming on line, that would yield major pollution reductions at costs well below the marginal costs of the tax you have proposed.

Mr. Chairman, the National Clean Air Coalition believes the tax proposal before you delivers on the fundamental goal of clean-air policy, pollution reductions on a fast-track. We are pleased to support it. We believe it will become the basis for a more detailed and comprehensive sulfur and nitrogen dioxide reduction program.

We believe the health of the American people and the needs of the human and natural environment demand prompt action. Thank you very much.

[The statement of Ms. Buffone follows:]

NATIONAL CLEAN AIR COALITION

SUSAN BUFFONE
Executive Director

KATHLEEN McGOUGH
Field Director

801 Pennsylvania Avenue, S.E. Washington, D.C. 20003 (202) 543-8200

STATEMENT OF SUSAN M. BUFFONE
EXECUTIVE DIRECTOR, NATIONAL CLEAN AIR COALITION
in support of
NATIONAL EMISSIONS TAX PROPOSALS

HOUSE COMMITTEE ON WAYS AND MEANS
WASHINGTON, D.C.
Thursday, July 9, 1987

Mr. Chairman and Members of the Committee, my name is Susan Buffone. I am speaking today as the executive director of the National Clean Air Coalition, representing more than two dozen environmental, public health, labor and public interest organizations and millions of Americans concerned with clean air.

The NCAC appreciates this opportunity to go on record in support of a national program to tax sulfur and nitrogen oxide emissions and emissions of chlorofluorocarbons. These pollutants are causing grave damage to the human and natural environment. The nation has an enormous financial and physical stake in their reduction. Given the apparent difficulty in addressing a reduction program in other forums, the Congress and the country would owe you a debt of gratitude if you enact these provisions.

The National Clean Air Coalition believes a tax on CFCs is a useful tool in the context of an overall reduction and eventual phase-out of these long-lived destroyers of the earth's protective ozone layer. The Coalition wishes to thank Congressman Stark for his leadership on this issue. His action stands in sharp contrast to Interior Secretary Hodel's efforts to trivialize this issue.

Since others today will address the CFCs proposal in detail, I will confine the balance of my statement to the proposed tax on sulfur and nitrogen oxide emissions. It is based on legislation sponsored by Congressmen Gregg and Downey. We wish to commend them for their effort to move

forward on an acid rain control program despite the apparent stalemate in other House forums.

These pollutants are a major health and environmental concern in America today. They are so common and so dangerous to humans that direct exposure is regulated through national ambient air quality standards designed to protect human health with an adequate margin of safety. In the atmosphere these pollutants often transform into particle form, becoming major contributors to unhealthful levels of airborne particulate and to the destruction of air quality in our national parks and elsewhere.

And they are the principal precursors of acid deposition, or "acid rain," a long-term pollution problem whose symptoms include dead and dying species of plants, animals and fish; reduced forest growth; damage to buildings, monuments, structures and other parts of the human environment; and secondary health effects, as aluminum and other metals are leached into water systems.

Mr. Chairman, a spokesman for the American Lung Association has called sulfur pollution the third leading cause of lung disease, after active and passive smoking. A recent Harvard University study estimated that the combined effects of particulate and sulfate pollution cause perhaps five percent of all deaths in the average polluted urban area. Earlier studies have estimated that sulfates are a major factor in 50,000 premature deaths in northeastern North America each year.

These studies are so frightening in their implications, Mr. Chairman, that supporters of clean air legislation hesitate to cite them for fear they are beyond belief. Admittedly, the evidence is not direct, but statistical. But the evidence is mounting that the federal response to sulfur and nitrogen oxide control has been tardy and inadequate.

The proposal before you to tax sulfur and nitrogen dioxide emissions at 45 cents per pound is one way to improve the federal response. It is by no means the only way. My colleagues in the environmental community are also testifying this morning in the Energy and Commerce Committee, in support of a more detailed response that we also support, and that many would prefer.

But studies by the Congressional Budget Office and others suggest the approach you are considering would accomplish the fundamental goal of any clean air program--it would reduce the pollutants of concern, and it would get results quickly. Beyond that, it would give the polluters

their choice of control based on their own economic, engineering and geographic circumstances, a policy goal of many supporters of acid rain legislation.

And it would recognize another fundamental point that underlies much of the environmental legislation now on the books. That is, the environment ought not be a free and open dumping ground for the waste products of our industrial society. Whether it be effluent discharged into the water, chemicals disposed of on land or pollutants discharged into the air, the pollution has its costs.

Today, it is the American people who are bearing the cost of excessive sulfur and nitrogen dioxide pollution. The National Academy of Sciences estimates resource damage from acid rain amounts to $7 billion per year, an estimate that is almost certainly low. The American Lung Association surveyed recent cost studies and concluded that the health consequences of air pollution cost perhaps $40 billion per year in health care and lost productivity. The American taxpayer directly bears a portion of that cost in Medicare and Medicaid payments.

Particulate and sulfur pollution reductions required by the Clean Air Act of 1970 saved about $4.4 billion per year by 1978, according to a study for the Business Roundtable. A further 60% reduction would save up to $16 billion in mortality related costs, and another $25 billion in illness costs.

Unfortunately, sulfur dioxide pollution trends are on the way up after several years of decline. Your proposal would ask those whose pollution inflicts these costs on our people and our resources to pay a portion, not the total, but a portion, of the costs of that pollution in taxes to the federal government. If they choose, they may reduce their taxes--and reduce the financial impact of their pollution--by reducing their emissions of sulfur and nitrogen oxides.

Studies suggest that tax proposals similar to yours would yield a 10 million ton reduction in sulfur dioxide emissions and a comparable reduction in nitrogen oxides. And they suggest that the overall cost to the emitters would be comparable to least cost emissions reduction programs considered elsewhere. In the short term, the federal treasury would recoup for the common good some of the expense that pollution imposes on society. In the long term, society would be served two ways--by the revenue from a permanent tax, and by the benefits of substantial pollution reductions.

Let me conclude by touching briefly on five counter arguments you will hear.

Argument 1. "A tax is an inappropriate response to the problem."

Response: In the first place, sulfur and nitrogen emissions taxes are a perfectly appropriate source of revenue. Emissions taxes are in use around the world. Any tax you approve should be permanent, and it should be made clear that state utility regulators should only allow a pass-through of that portion of the tax that could not be avoided by more cost effective emission reductions. This would guarantee a stable source of revenue in the context of a responsible environmental plan.

In the second place, the tax code is always used to further the social as well as economic interests of the country. I am sure members of the committee would be hard pressed to name a single tax code provision that does not have an adequate justification as good social or economic policy. And every member knows dozens of provisions that are both.

Argument 2. "This problem should be addressed comprehensively."

Response: Let those who make the argument come forward with their program ideas. The National Clean Air Coalition supports pollution reductions on a rapid schedule. These taxes are one approach. Other approaches that more completely address the competing economic forces in the energy industry are acceptable to us. Indeed, we have aggressively advocated acid rain legislation since 1981, without a single appearance before this committee. We are continuing to work on a programmatic response. This tax would be an excellent starting point for a very effective program that responds to the subtleties of the problem.

Argument 3. "The energy industry is complicated, and continuous emissions monitoring would be required. Thus, the tax would be hard to administer."

Response: The Congressional Budget Office pointed out in 1986 that the utility industry is "relatively uniform," developing formula estimates would be "straightforward," and the administrative costs of the tax would be "small relative to revenues collected." In addition, many plants already monitor their emissions on a continuous basis, or are already required to. Many more will soon do so as well.

Argument 4. "The tax would put domestic manufacturers at a competitive disadvantage since energy costs would increase."

Response: This old saw is used against every tax proposal. Studies of energy use show energy represents a tiny portion of costs for virtually all manufacturing categories. Industries with relatively high energy use would have a stake in encouraging emissions reductions, and in pursuing energy conservation programs that make sense for many other reasons.

Argument 5. "The tax discriminates against high sulfur coal use."

Response: There are many ways to fashion a program that would virtually guarantee that mining employment in high sulfur areas remain stable as a reduction program is put into place. New jobs would open up in low sulfur coal areas, often in the same state as current high sulfur mines. And there are technological alternatives in use today and coming on line that would yield major pollution reductions at costs well below the marginal cost of the tax you have proposed.

Mr. Chairman, the National Clean Air Coalition believes the tax proposal before you delivers on the fundamental goal of clean air policy--pollution reductions on a fast track. We are pleased to support it. We believe it would become the basis for a more detailed and comprehensive sulfur and nitrogen dioxide reduction program. We believe the health of the American people and the needs of the human and natural environment demand prompt action.

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Mr. RANGEL. Let me thank the panel, and let me point out to Dr. Scott, that while I do not believe that taxes should be used as an educational vehicle as related to cigarettes, I want to commend you and the American College of Physicians for attempting to point out the dangers of cigarette smoking, and I do hope that you continue whatever programs that you have for the other part of the population. That you continue to vigorously attempt to educate the youngsters as well as older people as to what the dangers are of cigarettes and lung cancer.

And if the college has other programs that involve a public service that would deal with preventive medicine, in view of the very large percentage of our Federal budget that goes into health care, after the fact, since most of it is reimbursing physicians after they are sick, or reimbursing hospitals after patients are there, it would really help me a great deal because I would like to be able to join in that effort and to get my colleagues to be a part of this effort by the physicians and by the medical groups generally, to try to keep Americans healthy and not to have to deal with the problems that bad habits have caused, but to keep them from becoming sick in the first place.

And I know that is the thrust of your testimony, and I apologize if it appeared as though I was not appreciative of the effort that you are making. I wanted to state that.

Reverend McEwen, you were courageous enough to give us alternatives to excise taxes, and I assume there was an assumption on your part that we would have to raise some type of revenue if we are going to effectively, as a Congress and a nation, reduce the deficit.

Is that view shared by the rest of the panel, that this Congress will have to raise some money if we are going to deal with the deficit?

Is there anyone that believes that we can reduce the deficit without raising revenues?

Mr. DONAHUE. Mr. Chairman, I do not believe that the Congress will reduce the deficit without raising revenues. I do wish that another effort could be made—it does not appear that it will—to look at some of the spending categories.

As we know, we are not talking about a tax to take care of a relatively fixed level of expenditure and deal with the deficit in that regard. We are talking about a tax to handle increased expenditures, but the gentlemen on your committee, and the ladies, have a very difficult time because we have one of those—Hobson's choice. We have defense and we have Social Security that nobody wants to touch. Then we have a relatively small percentage of discretionary spending.

And if you leave revenue collections where they are, although they are continuing to grow because of a stronger economy—every percentage in growth is 30-some billion dollars of revenue—I think you will probably go to revenue. I think the reality is that that is what you will do. I wish you would do something other.

Mr. RANGEL. Well, assuming that we will—and you can take my word for it—we will come up with a tax bill—will all of you agree that if we take excise taxes off of the table, that we will have to

revisit the rate system and the individual and corporate tax structure?

Dr. SCOTT. Well, Mr. Chairman, speaking as an individual, I have not actually reviewed this with my colleagues in the college, but certainly, I believe that if excise taxes were taken off the table, it seems inescapable you would have to come up with other proposals to get some more money into the Federal Treasury.

Mr. RANGEL. Does anyone disagree with that? If we took excise taxes off the table—because Reverend, I hear about this promise, and reneging, and all of those things, but I did not promise anybody, and no one promises anybody in front of me, that once we reform the system that we were never going to revisit it, or that there was some length of time—as a matter of fact, when this question was raised, as to why are you reforming the system and not raising money to reduce the deficit, most everyone I heard said because when we do revisit it will be a more equitable formula and the poor would no longer be held hostage by the system and the wealthy will have some minimum tax or some liability.

So I do not know about all these promises, but it has become popular in recent weeks, since we have to get some money somewhere, and I am just hoping that if you are successful in getting us not to look at excise taxes—for whatever reasons you have stated—that you will be of some assistance to the Congress, and if you believe we have to raise the revenue, and supporting another unpleasant task, and that is raising taxes from the income system.

Reverend MCEWEN. Mr. Chairman, I was referring to a newspaper account of Chairman Rostenkowski's answer to a reporter, that he would not want to renege.

It was Chairman Rostenkowski I was referring to.

Mr. RANGEL. You did not have to mention his name because he reminds me every week that we made this promise, and I know he has, and I know how strongly he feels about it, and it is not a very easy thing to do.

But Chairman Rostenkowksi had the support of the administration when we reformed the tax system, and they worked for the good of the Nation with this committee.

Now the President is just saying no, and even his most responsible Republican supporters are saying no as well. It is surprising. In any event, Mr. Frenzel.

Mr. FRENZEL. Mr. Chairman, I have no questions of the panel. I want to thank them for helping us with our deliberations and I yield the balance of my time.

Mr. RANGEL. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. You remind me of the fact that our chairman is not here but in the hospital, unable to defend his positions. I think that we should be kind and temperate in our thoughts, and our prayers for our chairman, so that he has a speedy recovery while we are at this.

I just have a couple of questions for the panel. I would like to thank them, and I would like to have their reaction to the fact that in 1971, 8.9 percent of taxes collected were from excise taxes, and today, they are down to 4.5 percent.

I would guess that Reverend McEwen says that is marvelous, that is the way to go. Does anybody else feel that way? Should they

have held steady on a percentage basis, or are they going in the right direction?

Mr. DONAHUE. Well, Mr. Schulze, if I may start, one knows that 4.5 percent of a very big pie is a lot bigger piece than 8.9 percent of a small pie. And if you look at the fact that—and we are talking about Federal excise taxes here. This year, 18 States have put increases into effect in their fuel taxes, and other excise taxes, and there are 4 or 5 more working on it.

There has been a 275-percent increase in Federal diesel tax increases since April of 1983, and a 15-cent increase in the cost of fuel in the last 8 months. We have had taxes on beer that have increased approximately 600 percent in the last 30 years.

So I think you have to be very careful, of all witnesses, including ourselves, when we start using percentages. It is percentages of what. I think it becomes clear to us, and the point we are trying to make—at least I am—is that we all understand the concern for revenue. We all understand that excise taxes are identifiable, easy to collect, and easy to hide.

But the fact is that they all go back to the same place.

Mr. SCHULZE. Mr. Donahue, what we do is set national priorities on the Ways and Means Committee through the Tax Code.

Mr. DONAHUE. Yes, sir.

Mr. SCHULZE. And percentages, I think, are a fairly accurate way to measure, no matter how big the pie gets, it is still a percentage of a larger pie, and therefore a relative constant, and we are getting a lesser degree of our income from excise taxes.

So I assume the bottom line is you are pleased with that and think that is the direction to go, is that right?

Mr. DONAHUE. Well, the only issue I would take with you, sir—I hope when you figure out your statistics, you will add in the States who now see, over the last 20 years, a major source of their revenue, not only for what has traditionally been highways and safety, and other matters—but for general income, is now coming from excise taxes.

Mr. SCHULZE. Of course much of that, when you are talking about highway taxes, and so forth, is pretty well recycled. That just goes right out——

Mr. DONAHUE. But you know, sir, every recycling comes out of somebody's pocket, and the recycling is from the private sector to the public sector.

Mr. SCHULZE. Exactly. Also, much of that is for the benefit of the private sector. I do not know how you could run a highway system through the private sector. I do not know of any other way that you could do what we do with Highway Trust Fund——

Mr. DONAHUE. No, and I do not think anyone is arguing with that, Mr. Schulze, except that we do have $13 billion that we are leaving in the trust fund and not spending, while we are talking about additional taxes, because we do not want the deficit to look any worse than it is now.

Mr. SCHULZE. Thank you. As Mr. Gardiner, and Mrs. Buffone were speaking, I asked my staff to go get me an article that triggered my memory, from the Washington Post, wherein it states that "Recycling a single Sunday edition of the New York Times could leave 75,000 trees standing."

Have you thought about recycling in your legislative——

Mr. GARDINER. Recycling is a great idea.

Mr. SCHULZE. And whether we could use this as an opportunity to raise funds, and are either of your organizations prepared to propose such a proposal?

I understand that Japan, many other nations, are away ahead of us, and that newspaper newsprint, some of these other products, are easily recyclable, but we have got to create a little incentive for people to do it.

Have you looked into that, or have any recommendations along those lines?

Mr. GARDINER. Not specifically. Our proposal today is limited to the taxes on pollution which you are considering. I do not think we have any particular——

Mr. SCHULZE. Is your goal to increase taxes or to save trees?

Mr. GARDINER. Our goal here today is to help you in your task to find the revenue which you need to come up with, and we believe that there is a way to do that, in a way that will substantially improve the health and safety, and the environment for all Americans.

Mr. SCHULZE. Your goal is to increase taxes, not save trees?

Mr. GARDINER. Well, I have participated on behalf of the Sierra Club in a working effect with about a half a dozen other environmental organizations a year ago, in which we analyzed the Federal budget to look for ways to deal with the deficit problem.

We have looked at those areas of the budget in which we had expertise, and we could find very few numbers of budget cuts that we could make that could help us, and we feel——

Mr. SCHULZE. If recycling a single Sunday edition of the New York Times could save 75,000 trees, that does not——

Mr. GARDINER. Oh, I agree with you.

Mr. SCHULZE [continuing]. Touch your "hot" button and——

Mr. GARDINER. No, absolutely. Recycling is——

Mr. SCHULZE. That does not turn the Sierra Club on?

Mr. GARDINER. No, recycling, generally speaking, yes, we do. We are very supportive of recycling efforts. I thought you were seeking some question about how we would be changing tax policy to encourage recycling, and on that, I——

Mr. SCHULZE. Sure. How else are you going to do it, unless you say we will give you a tax benefit if you use recycled newsprint, or something? I do not know. I guess that is your area of expertise, but you tell me you have not looked at it and it is not really important.

I am frankly shocked, on behalf of the Sierra Club, and I thank you for your testimony.

[The following was subsequently received:]

NATIONAL CLEAN AIR COALITION,
Washington, DC, July 15, 1987.

Hon. RICHARD T. SCHULZE,
U.S. House of Representatives
Washington, DC.

DEAR CONGRESSMAN SCHULZE: At the July 9 hearings of the Ways and Means Committee you inquired as to the National Clean Air Coalition's position on recycling. Since I was not provided an opportunity to respond at that time I wanted to set the record straight.

The National Clean Air Coalition strongly supports recycling. In the 100th Congress, we have advocated the need for recycling requirements in proposals to control the discharge of emissions from municipal waste incinerators.

As a precondition for approval of a garbage burning incinerator, communities should adopt enforceable plans to implement local recycling and waste reduction measures to the maximum extent practicable. Further, communities should be required to design the municipal waste incinerator plant's capacity based on the maximum practicable use of recycling and waste reduction alternatives.

A trash analysis done for the Federal Republic of Germany in 1979 and 1980 showed that 46.4% of the Republic's trash was recyclable.

Recycling can dramatically reduce the volume of refuse which must be burned.

I appreciate the opportunity to respond to your question.

Sincerely,

SUSAN BUFFONE,
Executive Director.

Mr. RANGEL. Mr. Gregg.

Mr. GREGG. Thank you. I certainly want to congratulate the Sierra Club and the National Clean Air Coalition for testifying today on behalf of mine, and Mr. Frenzel and Mr. Downey's bills. The points you make I think are excellent, and you summarize the arguments for a sulfur and nitrogen tax very appropriately.

In response to the comments made by Mr. Schulze, I think that basically what you are saying is, that here is a way that we can raise some revenue for the Federal Government, and, at the same time, take a major step forward towards improving the health of the country, and the environmental quality of those areas that are especially being impacted negatively by acid rain. Is that correct?

Mr. GARDINER. That is absolutely correct. And I think that one of the things which we did not discuss earlier, is that there has been a myth around that. It has been promoted by the opponents of acid rain control legislation, that somehow the damage from acid rain is limited perhaps to a few lakes in the Adirondacks or in New England, when in fact acid rain is both a public-health problem but a national problem, and that acid rain is now found in the Rockies, in Colorado.

It is found in Texas. Florida has the highest number of acidified lakes in the country. It is clearly a national problem, and a nationwide tax on these emissions will help solve the problem and produce benefits all across the country.

Mr. GREGG. I take it that is your position also, Mrs. Buffone?

Ms. BUFFONE. That is right. We are not necessarily interested in raising revenues. We are interested in cleaning the air.

Mr. GREGG. But we have got sort of a double plus here.

Ms. BUFFONE. A double benefit here.

Mr. GREGG. If you are interested in raising revenues, as the majority side seems to be, they can get $5 billion of revenues, or if they double the tax, as proposed by the Sierra Club, maybe as much as $10 billion of their $19 billion, and they can also improve the health and environment of the country as a whole. Is that correct?

Ms. BUFFONE. That is correct.

Mr. GREGG. Thank you. Unfortunately we have to leave to vote. I yield to Mr. Frenzel.

Mr. FRENZEL. I probably should have mentioned in my time, too, how much I appreciate the gentleman's leadership on the acid-rain proposal which I hope will lift us out of what has been a multiyear

stalemate. I want to say at this time how grateful I am to him for his work on it.

Mr. GREGG. Well, I certainly thank the gentleman from Minnesota's cosponsorship because of his exceptional credibility among the tax community, on this committee, and he lends it a lot of credibility. And I certainly hope that this committee will take up these bills and maybe move along this issue, as it has clearly been mired in another committee, which is unfortunate. Thank you very much.

[Pause.]

Mr. PEASE [presiding]. The current chairman is operating at a bit of disadvantage now, not having been here for your testimony. I will not therefore ask any questions.

We do appreciate very much your testimony today, and we will let you go, have some lunch, and we'll call up the next panel.

Thank you very much.

Mr. FRENZEL. Will the chairman state his intentions for the rest of the day? I understand we'll have two votes in a row here.

Mr. PEASE. Yes. It's the Chair's intention to continue without interruption.

Mr. FRENZEL. There's another vote.

Mr. PEASE. I have voted. Frank is on his way to vote, and he's going to relieve me.

Mr. FRENZEL. All right.

Mr. PEASE. We'll just start and go ahead.

All right, the next panel consists of Matthew Myers, staff director for the Coalition on Smoking OR Health; Peter Strauss, chairman, legislative and tax committee for the National Association of Tobacco Distributors; Fred Bond, chief executive officer of the Flue-Cured Tobacco Cooperative Stabilization Corp.; and Bernard Midden, immediate past president for the Council for Burley Tobacco.

Mr. Myers, you're seated. If you are ready why don't you begin?

STATEMENT OF MATTHEW L. MYERS, STAFF DIRECTOR, COALITION ON SMOKING OR HEALTH

Mr. MYERS. Fine. Thank you, Mr. Chairman.

My name is Matthew Myers, and I'm the staff director of the Coalition on Smoking OR Health. We have submitted our statement for the record. What I would like to do is to divert from it and briefly summarize a number of key points.

I am here today testifying on behalf of the Coalition on Smoking OR Health, which consists of the American Cancer Society, the American Heart Association, the American Lung Association, and their 5 million-plus members.

In addition to the coalition, on the issue of raising the excise tax on cigarettes, has been working with an ad hoc group of an additional 49 national organizations, including organizations such as the American Association of Retired Persons, the Children's Defense Fund, the YWCA, the National Council on Aging, the American Medical Association, and a host of additional health and poverty related groups.

We are here today to endorse an increase on the cigarette excise tax. In our view, an increase in the cigarette excise tax represents

good health policy and good economic policy. It's part of a comprehensive program in this Nation to encourage our Nation's youth not to smoke.

While we're here talking today just about cigarette excise taxes, our organizations are working on a wide variety of programs to encourage people not to smoke and to assist people who are smoking to quit.

In addition, we're working with Members of Congress in a wide variety of programs to further both of these goals.

Today I would like to focus on four primary issues. First, the impact of an increase of the excise tax on cigarette consumption. This is one issue on which I think every member of this panel probably will agree, and that is that an increase in the cigarette excise tax will in fact result in a decrease in consumption of cigarettes.

What is truly significant to those of us who care about the health of our Nation is who is smoking and who this excise tax will have the greatest impact on.

As a direct result of the marketing effort of the cigarette manufacturers, not the gentlemen sitting with me, every year close to 2 million people, 90 percent of them teenagers and young children, start smoking for the first time. That means that today alone 5,000 to 6,000 children will become addicted to cigarettes in a large part as a result of the marketing efforts of the cigarette manufacturers. Sixty percent of them will be 14 years old or younger. This is truly a national tragedy.

The key to the cigarette excise tax is that it will have its greatest impact on precisely this population. A 10-percent increase in the price of cigarettes will result in a 14-percent decrease in consumption among our Nation's youth. The proposed 16-cent increase will mean that 800,000 children fewer will start smoking this year.

The long-term health benefit and economic benefit to those children and our Nation's health is so large that it is difficult to count.

In addition to the effect on consumption, a cigarette excise tax makes good economic policy.

As you have already heard, cigarette smoking costs our country billions of dollars every year. It costs the Federal Government 4.2 billion in Medicare costs. It costs $210 million in increased costs of the Veterans' Administration nationwide, we spend $22 billion on health care costs directly related to smoking.

In addition, since so much of our concern is on productivity and competitiveness, it is critical to realize smoking's impact on our competitive position; every year we lose $43 billion in productivity as a direct result of smoking related illness.

It only makes sense, since cigarette smoking contributes so much to the Federal deficit, that it should pay some of that back.

In the few remaining moments, I would like to touch on two additional issues.

The first is the issue of fairness about which you've heard so much and will hear more. And the second is the relative tax burden on cigarettes.

First, fairness, and I'd like to divide that into two issues: fairness to tobacco farmers, and fairness to consumers.

It's ironic that cigarette manufacturers point to the excise tax increase as the major cause of the problems of tobacco farmers in

this country. It's ironic because it ignores the fact that their decision to import nearly one-third of all the tobacco in every cigarette is the real reason for decreased use of American tobacco in this country.

It's ironic because, in the last 12 months, cigarette manufacturers have increased the wholesale price of cigarettes 16 percent. That increase comes at a time when inflation rates were less than one-third of the increase, and at a time when cigarette manufacturers had just finished convincing Congress to reduce the price the manufacturers were paying our farmers for the tobacco.

If the farmers are concerned about their plight, the place to look is to the manufacturers who put them there.

This brings me to our greatest area of concern. Fairness to the poor; fairness to consumers. This is a real and serious concern of this committee and to all of our organizations. That is why we are devoting substantially increased resources to educational and other programmatic efforts to help encourage the poor and minorities not to smoke.

Again I cannot but help denote the irony. While the cigarette manufacturers talk about the regressive nature of a tobacco tax, they are targeting our Nation's youth and our Nation's minorities as the greatest growth market for cigarette smoking. This hearing is timely. Only this week, Newsweek carried a story that pointed out that mortality rates among the poor, and particularly among minorities, are nearly twice that for the wealthy and for whites for cancer, heart disease and chronic obstructive lung diseases, all of which are smoking related diseases.

The real problem for the poor is not the cigarette excise tax. It's the toll of smoking on those people.

The final issue I just want to briefly address is about how much you are going to hear that the tax burden on cigarettes has increased. In fact, it hasn't. Federal taxes in 1951 represented 42 percent of the cost of a pack of cigarettes. Today they represent less than 16 percent of the cost of a pack of cigarettes.

Between 1954 and 1973, the total State and Federal tax share of the retail price of cigarettes was never less than 46.6 percent. Today it has dropped by a third, even with the 1982 price increase, to approximately 32 percent. Thus, the relative tax burden on cigarettes has steadily been going downhill, not up.

Thank you.

[The statement of Mr. Myers follows:]

Statement
of the
American Cancer Society
American Heart Association,
and American Lung Association
as the Coalition on Smoking OR Health

The American Cancer Society, American Heart Association, and American Lung Association welcome this opportunity to testify before the House Committee on Ways and Means on options to increase federal revenues as part of the effort to lower the federal deficit. Specifically, we urge this Committee to increase the federal cigarette excise tax.

Five years ago, our three organizations reached agreement that the serious health consequences related to cigarette smoking were of such concern that we should work as a coalition to seek enactment of a variety of legislative initiatives. From that agreement, the Coalition on Smoking OR Health was formed.

Today, at a time when 60 percent of smokers begin smoking by the age of 14, with 90 percent starting to smoke by age 19, tobacco use, especially among our nation's youth, remains a primary concern of each of our organizations. This year, over 300,000 Americans will die from smoking-related illnesses. Cigarette smoking will account for approximately 83 percent of all lung cancer deaths and 30 percent of all cancer deaths. An estimated 80 to 90 percent of all chronic obstructive lung diseases will be attributable to cigarette smoking. Likewise, a significant percentage of coronary heart disease deaths will be directly linked to smoking. In total, one out of every seven deaths in the United States will be smoking-related.

In an effort to discourage consumption, our organizations support a 16 cent increase in the federal cigarette excise tax, which is listed among the revenue options that the Committee will consider as part of its debate on budget reconciliation alternatives. A cigarette excise tax increase makes good sense from two perspectives. It is good health policy because it discourages the use of cigarettes. And it is good economic policy because it raises significant revenues.

The primary basis for our support of a cigarette excise tax increase is the important health benefits that we believe will necessarily accrue. Cigarette consumption is inversely related to price, i.e., as price increases demand decreases, particularly among young people who decide not to smoke at all. A 1986 analysis by Michigan University economist Kenneth E. Warner, as well as a number of earlier studies, confirmed that "cigarette excise tax changes ultimately influence the health of smokers and nonsmokers."

More specifically, Warner's analysis revealed than an eight cent increase in the federal cigarette excise tax, from the current level of 16 cents to 24 cents, would encourage 1.8 million individuals to quit or not start smoking. He found the effect greatest among teenagers. Thus, Professor Warner found that more than 400,000 teenagers and more than 500,000 young adults aged 20 to 25 years would quit or not start smoking as the result of an eight cent increase in the federal cigarette excise tax.

Doubling the federal cigarette excise tax, as proposed in the Committee's revenue options list, yields even more impressive results. According to Warner, "a 16 cent increase in the excise tax would encourage almost 3.5 million Americans to forego smoking habits in which they would engage if the tax were to remain at 16 cents per pack. This figure includes more than 800,000 teenagers and almost 2 million young adults aged 20 to 35 years." Professor Warner concluded that the proposed doubling of the federal cigarette excise tax would diminish the teenage smoking population by 17 percent.

A strong argument also exists that an increase in the cigarette excise tax is justified by the economic burden that cigarette smoking now imposes on society, in general, and on the federal government, in particular. A major analysis completed by the Office of Technology Assessment (OTA) in 1985, concluded that our nation incurs an estimated $65 billion annually in smoking-related health care and lost productivity costs. Smoking-related health care costs alone were estimated at $22 billion annually, or approximately six percent of Gross National Product (GNP). An estimated 75 percent of these costs were believed to be incurred by those under age 65. Annual lost productivity costs, including smoking-related absenteeism and disability were estimated at $43 billion.

Many of these smoking-related costs are borne by the federal government. According to OTA, annual federal government smoking-related health care outlays include $4.2 billion in Medicare and Medicaid payments. Other federal government outlays include $210 million through the Department of Defense and $400 million by the Veterans Administration. These estimates are

conservative. OTA only considered government program cost estimates for persons aged 65 and over. The analysis did not take into account the previously-mentioned statistic, that 75 percent of smoking-related health care costs are incurred by those under the age of 65. Indeed, other analyses have suggested that the federal government's health care cost may well exceed $6 billion annually.

The OTA analysis supports the conclusion that cigarette smoking directly contributes to our nation's federal deficit. We believe that those who smoke should bear some responsibility for these increased costs. In this sense, the cigarette excise tax is like a "user fee".

However, some would argue that it is unfair to balance the burden of the nation's federal deficit on the backs of our nation's smokers, many of whom are considered middle and lower income Americans. Some express concern with the potential regressive nature of a cigarette excise tax increase, i.e., that any increase would consume a larger portion of the income of middle and lower income Americans than would be experienced by wealthier individuals.

We are extremely concerned about and sensitive to the impact of this tax on the poor. Nonetheless, we believe that among all the possible excise taxes this is the fairest and most justified.

First, it is cigarette smoking itself that has the greatest negative impact on the poor because it is the poor who are least able to afford the health care needed to cope with smoking-related disease. It is ironic that on this issue representatives of the tobacco industry express great concern for the poor while their advertising and marketing shamelessly is increasingly targeted at the poor in an effort to manipulate their attitudes to encourage them to smoke more. Interestingly, while the tobacco industry has been extremely vocal in its concern regarding regressivity, the industry's three most recent price increases over the past 12 months have caused the wholesale price of a carton of cigarettes to increase by nearly 16 percent.

Second, an increase in the cigarette excise tax will ensure that those who smoke will pay the federal government a greater proportion of the Medicare, Medicaid and other federal health care expenses that are directly tied to cigarette- related disease. In these days of fiscal restraint, it is no longer fair to ask those less advantaged Americans who have chosen not to smoke to bear the health care related financial burden of those who have chosen to smoke.

Third, even a 16 cent increase in the federal cigarette excise tax would not quite bring the tax to the level it would have been had the tax been adjusted for inflation since 1951.

Fourth, while any increased tax burden is difficult for the poor, the proposed 16 cent increase in the federal cigarette excise tax amounts to a smaller increase per person than most people realize. The average one-pack-per-day cigarette smoker already spends approximately $400 on cigarettes per year. An increase in the cigarette excise tax would result in the average cigarette smoker paying slightly more than $1 per week in higher cigarette prices. This sum is even less for poorer smokers because the data consistently show that while more poor people smoke, they each smoke substantially fewer cigarettes per day than the average smoker.

Finally, cigarettes are unique among the products on which excise taxes may be imposed. We recognize the unfairness in imposing increased excise taxes on items like gasoline or telephone usage, both of which have become near essentials in our society. Cigarettes are not an essential. Instead, they are a product that when used as intended will often result in severe disability, and all too frequently, death.

Some argue that tax policy should not be an instrument of social policy. They argue that it is irrelevant that an increased cigarette excise taxes will save lives by discouraging people from smoking. The reality is that virtually all taxes either affect people's behavior or have a disproportionate impact. Thus, at least it makes sense to recognize the impact and adopt a tax whose effect on behavior will be positive.

For these reasons, the American Cancer Society, American Heart Association, and American Lung Association urge enactment of a 16 cent increase in the federal cigarette excise tax.

Mr. PEASE. Thank you, Mr. Myers.
Our next witness will be Mr. Strauss.

STATEMENT OF PETER STRAUSS, VICE PRESIDENT AND MEMBER, BOARD OF DIRECTORS, NATIONAL ASSOCIATION OF TOBACCO DISTRIBUTORS, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, METROPOLITAN DISTRIBUTION SERVICES, INC.

Mr. STRAUSS. Mr. Chairman, my name is Peter Strauss, and I am here representing the National Association of Tobacco Distributors, an organization of over 570 wholesaler-distributor members operating in every State, and 230 manufacturer and supplier associates.

We canvas and supply almost 1½ million retail outlets selling tobacco, candy products, health and beauty aids, groceries, and many sundry products across the United States with an estimated annual wholesale value of over $16 billion.

We applaud you and your colleagues for the enactment of last year's Tax Reform Act. The legislation brought a measure of fairness to the Federal Tax Code by placing a greater share of the tax burden on those most able to pay.

The issue we would like to address today is that of fairness, fairness to individual taxpayers and fairness particularly to small business people that threatens to be the first casualty of the process to reduce the deficit.

In the past few months, a number of studies, and the most notably by the Congressional Budget Office, have confirmed the fact that excise taxes are clearly regressive, that cigarette taxes are the most regressive of all excise taxes, and that an increase in excise taxes in the magnitude currently being discussed would effectively eliminate the income tax reduction, low and moderate income taxpayers expect to receive from the Tax Reform Act of 1986.

Mr. Chairman, the issue of fairness is not new. It was with us at the beginning. Alexander Hamilton wrote in the Federalist Papers about the principles of taxation, and said:

> The man who understands those principles best will be least likely to resort to oppressive expedients, or to sacrifice any particular class of citizens for the procurement of revenue. It might be demonstrated that the most productive system of finance will always be the least burdensome.

Mr. Chairman, the studies I referred to and the lessons of our history clearly illuminate the fact that raising excise taxes is not the least burdensome system.

It is often said that facts speak for themselves, but only if they are facts. There are some myths surrounding the tobacco industry in general, and the wholesale distribution industry in particular, which I would like to dispel.

Myth: Cigarette excise taxes have not kept pace with inflation.

Fact: The increase in the CPI from 1951 to 1985 was 421 percent. The aggregate Federal, State, and local cigarette tax collections in the same period increased 601 percent.

Myth: The tobacco industry is big business and will not be adversely affected by an increase in excise taxes.

Fact: The average tobacco distributor is a small family-owned and operated business with limited capital. A 16-cent increase in

every pack of cigarettes will force most distributors to go to the commercial market to finance the additional cost of inventory.

Myth: Wholesalers can simply pass on any additional costs on to the retailer.

Fact: The wholesale distribution system is highly competitive. The wholesaler who passes on all costs, including the financing of loans to pay for inventory, would not remain competitive and is likely to lose customers.

Mr. Chairman, the overriding fact is that the cigarette industry already pays its fair shares of taxes. Over $9 billion last year to Federal, State, and local governments.

Federal excise taxes impinge upon traditional sources of State and local revenue, such as sales taxes. Any actions to increase the Federal excise tax on cigarettes will be magnified in their effects on the ultimate consumer by virtue of the increases automatically generated at the State and local levels, thereby only multiplying the regressive factors inherent in this kind of taxation.

The wholesale tobacco and candy distributors of this country ask that you strike from your list of revenue options any consideration of increasing cigarette excise taxes.

However, since we recognize that among all the competing interests which you must consider, some will lose the battle. We must also take this opportunity to be heard about the implementation of a cigarette excise tax increase should our basic plea go unheeded.

I again refer to the issue of fairness. This time with respect to the imposition of a floor-stocks tax on wholesalers. To repeat the injustice of 1983 would be unfair.

You are aware that the Federal excise tax on cigarettes is imposed at the manufacturing level. To impose a floor-stocks tax on the wholesalers, the man in the middle and at the same time exempt the retailer, as was done in 1983, cannot be justified on any grounds other than the most arbitrary, particularly in light of the fact that the incremental one-time gain in revenue, net of expenses, is minuscule. On the other hand, there is palpable and serious hardship imposed on the distributor by a floor-stocks tax. Indeed, the options papers prepared by the Joint Committee staff state, "Floor stocks taxes impose administrative burdens on retail and wholesale dealers in taxable articles."

We have prepared a very thorough report on this issue, which I ask your permission to be inserted in the record at this time.

Mr. PEASE. How long is it?

Mr. STRAUSS. Sir?

Mr. PEASE. How long is it?

We will make a point, a reservation at this point, and ask the staff to look at the length of it and see if it's practical.

Mr. STRAUSS. Thank you.

The most important points made in that report are that direct buying retailers, many of whom are larger than many wholesalers, have been exempt from floor-stocks tax, which puts the wholesaler at a severe competitive disadvantage.

Penalizing the wholesaler by not allowing him the same inventory gain opportunities as the retailer is not fair, particularly in light of the distributor's extra costs associated with financing inventory costs imposed by an increased excise tax.

An excise tax increase will exaggerate the decline in cigarette consumption, as it did after 1983. And in doing so will also exacerbate the deteriorating economic status of this country's wholesale tobacco and candy distributors.

A floor-stocks tax adds insult to this injury. It is virtually impossible for a floor-stocks tax to be implemented at the retail level. Therefore, it is our contention that, in the interest of fairness, common sense and the economic stability of the wholesale distribution industry, no floor-stocks tax shall be imposed at wholesale in the event the excise tax on cigarettes is increased.

By law, the Federal excise tax on cigarettes is a liability placed on the manufacturers. The Government should not use the event of an excise tax increase to penalize the thousands of small businesses that are represented by the wholesalers of this country.

Thank you very much for providing us the opportunity for presenting our views.

[The statement of Mr. Strauss and subsequently received material follow:]

STATEMENT OF

PETER STRAUSS
VICE PRESIDENT AND MEMBER, BOARD OF DIRECTORS
NATIONAL ASSOCIATION OF TOBACCO DISTRIBUTORS

BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE

JULY 9, 1987

Mr. Chairman and members of the committee, my name is Peter Strauss, President and CEO of Metropolitan Distribution Services, Inc., Flushing, New York. I am also a Vice President and Chairman of the Legislation and Tax Committee of the National Association of Tobacco Distributors.

Our Association represents over 570 corporate wholesaler-distributor members with over 740 distribution outlets in every state and represents 230 manufacturer and supplier associates. Their 12,000 salesmen together with our own canvass and supply almost 1.5 million retail outlets selling tobacco and candy products across the United States. It is estimated that our members market goods with an annual wholesale value of over $16.0 billion dollars.

NATD is also a member of CART, the Coalition Against Regressive Taxation.

Mr. Chairman, I appreciate the opportunity to present the views of the association with respect to increasing excise taxes. As a CEO of a corporation and as an individual taxpayer, I certainly applaud you and your colleagues for the enactment of last year's Tax Reform Act. The legislation brought a measure of fairness to the federal tax code by placing a greater share of the tax burden on those most able to pay and, in what I believe to be the most equitable part of the bill, reduced or eliminated the tax burden on those least able to pay.

The issue we would like to address today is fairness -- fairness to individual taxpayers and fairness to small business people. It is inconceivable that before the new elements of tax reform are even implemented, one of its cornerstones -- fairness -- threatens to be the first casualty in the budget process.

Let me state for the record that we are not opposed to measures intended to reduce the deficit; but we are adamently opposed to placing the burden on the very people last year's tax bill was intended to help.

In the past few months a number of studies, most notably by the Congressional Budget Office, the accounting firm of Peat Marwick Main and Company, and Citizens for Tax Justice, have been released. These studies analyzed the effect of additional excise taxes on different income categories and all confirmed the fact that excise taxes are clearly regressive. Indeed, the CBO study found cigarette taxes to be the most regressive of all excise taxes.

More importantly, these studies found that an increase in excise taxes of the magnitude currently being discussed would effectively eliminate the income tax reduction low and moderate income-tax payers expect to receive from the Tax Reform Act of 1986.

According to CBO, the average increase in taxes as a percentage of total income would be between two and three times as large for families with incomes between $10,000 and $20,000 as compared to families with incomes of $50,000 or more, depending upon the product being taxed. In the case of cigarettes it is a multiple of three.

Mr. Chairman, the issue of fairness is not new. I need not remind this body, on the 200th anniversary of our Constitution, of the part it played in our earliest origins as a Nation, and in the drafting of that document. However, it never hurts to repeat what Alexander Hamilton wrote in The Federalist Papers:

> "There is no part of the administration of government that requires extensive information and a thorough knowledge of the principles of political economy so much as the business of taxation. The man who understands those principles best will be least likely to resort to oppressive expedients, or to sacrifice any particular class of citizens to the procurement of revenue. It might be demonstrated that the most productive system of finance will always be the least burdensome."

Mr. Chairman, the studies I referred to earlier and the lessons of our history clearly illuminate the fact that raising excise taxes is <u>not</u> the least burdensome system.

It is often said that facts speak for themselves, but only if they <u>are</u> facts, and not myths such as those surrounding the tobacco industry in general and the wholesale distribution industry in particular.

MYTH: Cigarette excise taxes have not kept pace with inflation.

FACT: The increase in the CPI from 1951-1985 was 421%. The aggregate federal, state and local cigarette tax collections in the same period increased 601%.

MYTH: Cigarette excise taxes have not been raised for over five years.

FACT: Excise taxes on cigarettes were "technically" raised last year. In 1982 the excise tax on cigarettes was doubled from 8 cents per pack to 16 cents per pack by the Tax Equity and Fiscal Responsibility Act (TEFRA) with the provision that the increase would "sunset" on October 1, 1986. The sunset date was postponed no less than five times by the Congress.

	Original Date	New Date
P.L. 99-107	Oct. 1, 1985	Nov. 15, 1985
P.L. 99-155	Nov. 15, 1985	Dec. 15, 1985
P.L. 99-181	Dec. 15, 1985	Dec. 18, 1985
P.L. 99-189	Dec. 18, 1985	Dec. 19, 1985
P.L. 99-201	Dec. 19, 1985	Mar. 15, 1986

March 15, 1986 came and went without an extension of the "sunset" date. However, on March 20, 1986 the Congress abolished the "sunset" date making the 8 cent increase permanent retroactive to March 15, 1986.

Thus, although the rate of the federal cigarette excise tax remained the same, it was technically an increase over the amount it would have been if the "sunset" was allowed to take place as Congress intended it when it adopted TEFRA in 1982.

MYTH: The tobacco industry is "big business" and will not be adversely affected by an increase in excise taxes.

FACT: The average tobacco distributor is a small family owned and operated business with limited capital. A 16-cent increase on every pack of cigarettes will force most distributors to go to the commercial market to finance the additional cost of inventory.

MYTH: Wholesalers can simply pass any additional costs on to the retailer.

FACT: The wholesale distribution system is highly competitive. The wholesaler who passes on all costs, including the

financing of loans to pay for inventory, would not remain competitive and is likely to lose customers.

Mr. Chairman, the overriding fact is that the cigarette industry already pays its fair share of taxes. Over $9.0 billion was paid in cigarette excise taxes last year to federal, state and local governments.

Finally, on the subject of the excise tax itself, it must be remembered that federal excise taxes impinge upon traditional sources of state and local revenue, such as sales taxes. Any actions to increase the federal excise tax on cigarettes will be magnified in their effects on the ultimate consumer by virtue of the increases automatically generated at the state and local levels -- thereby only multiplying the regressive factors inherent in this kind of taxation.

The specific industry I represent, the wholesale tobacco and candy distributors of this country, ask that you strike from your list of revenue options any consideration of increasing cigarette excise taxes.

However, since we recognize that among all the competing interests which you must consider some will lose the battle, we must also take this opportunity to be heard about the implementation of a cigarette excise tax increase should our basic plea go unheeded.

I again refer to the issue of fairness -- this time with respect to the imposition of a floor-stocks tax on wholesalers. To repeat the unjustice of 1983 would add insult to the injury of a tax itself.

You are aware that the federal excise tax on cigarettes is imposed at the manufacturing level. To impose a floor-stocks tax on the wholesalers -- the man in the middle -- and at the same time exempt the retailer as was done in 1983 cannot be justified on any grounds other than the most arbitrary -- particularly in light of the fact that the incremental, one-time gain in revenue, net of expenses, is minuscule. On the other hand, there is palpable and serious hardship imposed on the distributor by a floor-stocks tax. Indeed, the "options papers" prepared by the Joint Committee staff state, "Floor stocks taxes impose administrative burdens on retail and wholesale dealers in taxable articles."

We have prepared a very thorough report on this issue which I am submitting to the Committee rather than taking your time now. However, I would like to conclude my testimony with a brief executive summary of the most important points made in that report:

- Direct-buying retailers, many of whom are larger than many wholesalers, have been exempt from floor-stocks tax, which puts the wholesaler at a severe competitive disadvantage.

- Penalizing the wholesaler by not allowing him the same inventory gain opportunities as the retailer is not fair, particularly in light of the distributor's extra costs associated with financing the higher inventory costs imposed by an increased excise tax.

- An excise tax increase will exaggerate the decline in cigarette consumption -- as it did after 1983 -- and in doing so will also exacerbate the deteriorating economic status of this country's wholesale tobacco and candy distributors. A floor-stocks tax adds insult to this injury.

We recognize that it is virtually impossible for a floor-stocks tax to be implemented at the retail level. Therefore it is our contention that in the interests of fairness, common sense, and the economic stability of the wholesale distribution industry, no floor-stocks tax should be imposed at wholesale in the event the excise tax on cigarettes is increased. By law the federal excise tax on cigarettes is a liability placed upon the manufacturers. The government should not use the event of an excise tax increase to penalize the thousands of small businesses that are represented by the wholesalers of this country.

Thank you very much for providing us the opportunity for presenting our views.

NATIONAL ASSOCIATION OF TOBACCO DISTRIBUTORS

NATD

Chairman of the Board
William R. Hagman Jr.
The Hagman Corporation
Pittsburg, Kansas

President
Peter C. Gifos
Gifos Brothers, Inc.
Dalton, Massachusetts

Vice President-Finance
Jay Morin
Capital Distributors
Greenbelt, Maryland

Secretary
Fred Hayland
The Eli Witt Company
Tampa, Florida

Executive Vice President
Terry J. Burns
NATD
Alexandria, Virginia

July 22, 1987

Robert Leonard
Chief Counsel
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

As you begin consideration of the reconciliation bill and the various revenue options, there is a matter that the National Association of Tobacco Distributors would like to bring to your attention.

You may be aware that Peter Strauss, NATD's Legislative Chairman and President and CEO of Metropolitan Distribution Services, Inc. in New York testified before the Ways and Means Committee last week against raising excise taxes

Our specific concern is that, should our plea go unheeded, we believe that to impose a floor-stocks tax on the wholesalers -- the man in the middle -- and at the same time exempt the retailer as was done in 1983 is unfair and arbitrary. NATD urges the committee to exempt wholesalers from a floor stocks tax.

We believe the enclosed report justifies our arguments. In brief, the report makes the following points:

* Direct buying retailers, many of whom are larger than many wholesalers, have been exempt from floor-stocks tax, which puts the wholesaler at a severe competitive disadvantage.

* Penalizing the wholesaler by not allowing him the same inventory gain opportunities as the retailer is not fair, particularly in light of the distributor's extra costs associated with financing the higher inventory costs imposed by an increased excise tax.

* An excise tax increase will exacerbate the decline in cigarette consumption -- as it did after 1983 -- and in doing so will also exacerbate the deteriorating economic status of this country's wholesale tobacco and candy distributors. A floor stocks tax adds insult to this injury.

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We recognize that it is virtually impossible for a floor-stocks tax to be implemented at the retail level. Therefore it is our contention that in the interests of fairness, common sense, and the economic stability of the wholesale distribution industry, no floor-stocks tax should be imposed at wholesale in the event the excise tax on cigarettes is increased. By law the federal excise tax on cigarettes is a liability placed upon the manufacturers. The government, should not use the event of an excise tax increase to penalize the thousands of small businesses that are represented by the wholesalers of this country.

Enclosed is suggested language should an amendment be necessary.

Thank you very much for your attention to this important matter.

Sincerely,

Jacqueline A. Cohen
Director of Government Relations

Terry J. Burns
Executive Vice President

THE ECONOMIC IMPACT ON TOBACCO DISTRIBUTORS OF A FLOOR STOCKS TAX ON CIGARETTES

"HOW TO AVOID ADDING INSULT TO INJURY"

A PRESENTATION TO THE HOUSE WAYS AND MEANS COMMITTEE
HEARING ON REVENUE-RAISING OPTIONS

July 9, 1987

By Peter Strauss
Chairman, Legislative Committee
National Association of Tobacco Distributors

[BECAUSE OF THE LENGTH OF THIS STUDY, ONLY THE EXECUTIVE SUMMARY IS BEING PRINTED.]

1.0 EXECUTIVE SUMMARY

● TEFRA's 1982-83 floor stocks tax exemption for "on-premises" retail sales allowed retailers to load up on inventories, though not through distributors, who were encouraged to zero out their inventories. Many of the direct-buy retailers, including chain stores, had the financial resources to purchase such "load-in" excess inventories. These retailers are much larger than many tobacco distributors. Given the size of these outlets, their ability to hold vast inventories, and their success in 1983 at earning significant "windfall" profits, these retailers would plan this time around to make an even greater "killing" at the expense of the declining tobacco distribution sector (see Section 4).

● The 1983 TEFRA-induced discontinuity of supply created havoc for both manufacturers and distributors as the retail trade tried to walk off with a windfall profit, some legally and some not so legally (see Section 4).

● A careful reading of the US Code Title 26, Sections 5701 and following, clearly places the tax liability on the manufacturer, not on the distributor, raising the question of the legal ground for a floor stocks tax (see Section 4).

● By exempting distributors along with retailers, from a floor stocks tax, distributors will be in a better position to finance the higher-valued inventory, to finance the higher per unit costs, and to avoid the additional costs that administration of the floor stocks tax entails. The government would also save such enforcement funds (see Section 5).

● By subjecting distributors not only to losses in after-tax revenues and to increases in costs associated with financing the administration of the excise tax system, the federal government's further interest in obtaining a floor stocks tax adds "insult to the injuries" that will surely follow from a federal cigarette excise tax increase (see Section 5).

● For the past several years, the profitability of cigarette distribution in America has been contingent on regular price appreciations of inventories, caused generally by manufacturer price increases. Without this price appreciation of inventories, enabling distributors on a semi-annual basis to realize windfall profits, the razor-thin margins generated in cigarette distribution would vanish, leading many family-owned small businesses past the brink of solvency and into bankruptcy (see Section 2).

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- As with price increases, excise tax increases raise the value of inventories, not only in the short-term, but for all inventories later purchased by distributors. An 80 cent per carton tax hike, given a roughly $8 per carton current cost, is a 10% increase in inventory value. A doubling of the excise tax would raise inventory costs further, by 20%. Given the cash-flow sensitive nature of the distribution business, including the financing of accounts receivable, higher inventory costs entail higher financing costs (see Section 3).

- The floor stocks tax paid by distributors, after the 80 cent per carton increase in 1983, totalled $31.6 million (letter from BATF, see Appendix A). With cigarette consumption showing annual declines between 1983-87, a TEFRA level tax hike would yield even lower federal revenue from the floor stocks tax. Assuming no distributor floor stocks exemption, only $29 million is at stake this time around. This lost revenue is a small price to pay for continued stability in cigarette distribution (see Chart 1, Table 1 and Section 5).

- Assuming an 80 cent per carton increase in the cigarette excise tax, the cost to distributors to finance the total excise tax component of their total accounts receivable, would cumulatively exceed $41 million during FY88-91. This cost to the distributor is 41% more than the benefit the distributor would receive by receiving a floor stocks tax exemption (see Chart 2, and Section 3).

- Under TEFRA, the 80 cent per carton tax hike became a $1.14 per carton tax hike to the distributor. Excluding the 34 cent per carton difference, the cost to distributors to finance the total $2.40 (80 cent increase plus $1.60 current) excise tax component of their accounts receivable is estimated at $30.2 million over FY88-91. This amount is roughly equal to the benefit the distributor would receive through a floor stocks tax exemption (see Chart 2, and Section 3).

- If retailers were exempt from the floor stocks tax, while distributors were not so exempt, the nature of distribution will entail a short-term increase in the cost of returns, estimated at $.5 million (see Section 3).

- Higher taxes necessarily mean lower volumes for distributors. Lacking export capability, lower volumes necessarily entail greater excess capacity, which, in turn, means a lower return on assets, lower returns on

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unit of product distributed. Based on the CBO-assumed impact on volumes, 780.5 million fewer cartons will be distributed, during the period FY88-91, than would have been the case without an 80 cent per carton cigarette tax hike, and assuming the 1.6% current rate of decline in cigarette consumption. The additional lost cartons will have a cumulative $306 million effect on distributors' returns on net assets as distributors lose $348.1 million in net sales. These asset valuation effects, from even an 80 cent per carton cigarette tax hike, dwarf the income statement effects. Distributors are being asked to incur these injuries. The CBO calculations on the net revenue gains from an increase in the federal cigarette excise tax assume these volume reductions (see Charts 2 & 4 and Section 3).

- Since 66% of the average tobacco distributor's profits and 77% of his sales come from the cigarette product category of his total product mix, the injuries will be substantial (see Charts 3A-3D and Section 2).

[The full text of the study is being retained in committee files.]

Mr. PEASE. Thank you, Mr. Strauss.
Our next witness will be Fred G. Bond.

STATEMENT BY FRED G. BOND, CHIEF EXECUTIVE OFFICER, FLUE-CURED TOBACCO COOPERATIVE STABILIZATION CORPORATION

Mr. BOND. Thank you, sir.

I am Fred Bond, chief executive officer of the Flue-Cured Tobacco Cooperative Stabilization Corp. of Raleigh, NC. Our association, under contract with U.S. Department of Agriculture, administers the price support component of the Federal tobacco program for flue-cured tobacco growers in six States, Virginia, North Carolina, South Carolina, Georgia, Florida, and Alabama. Some 60,000 active farmers depend upon tobacco farming for their livelihood.

Through loans from the USDA's Commodity Credit Corporation, we subsequently make loans to growers for their tobacco which does not receive auction bids by commercial buyers above price support levels. As you may know, Congress has mandated, in 1982, that the tobacco program must operate at no net cost to the Government.

And may I stop here just to say, in spite of much of the news media, there is no tobacco subsidy to tobacco growers. All the funds that we borrow are repaid plus interest at the going rate. So there is no subsidy to the U.S. Flue-cured tobacco growers.

Last year, Congress passed legislation which significantly altered the tobacco program and made it possible for our association to substantially reduce excess inventory. Therefore, we are concerned about the factors which reduce demand for U.S. grown Flue-cured tobacco, one of the major ingredients in cigarettes.

We know from past experience that increases in cigarette excise taxes inevitably result in decreases in cigarette consumption. This in turn has a negative impact on the amount of leaf tobacco purchased at the auction markets and, thus, all growers sell less tobacco, and the co-op, our association, receives more tobacco leaf, thus raising the amount of money we must borrow from the Federal Treasury, and increasing the financial burden on those 60,000 active growers.

Not only do growers receive less money, but their financial obligation for tobacco placed under loan goes up. Hence, they are required to pay more to underwrite the cost of the program from reduced incomes. .

We have operated for 1 year under the revamped tobacco program and, at this point, we feel that changes that have been made have been successful. For example, in 1986, our association received only 7 percent of the total marketings. About 15 percent of marketings were placed under loan the previous year. I think you will agree that to reduce by 50 percent the amount of tobacco going to the co-op is a significant improvement.

In addition, the 1986 legislation authorized the purchase of our 1976 through 1984 inventory by domestic cigarette manufacturers. And, on July 2, 1986, we signed contracts exceeding $1 billion with four domestic companies to purchase approximately 584 million pounds of tobacco over an 8-year period. The companies were re-

quired to purchase at least one-eighth of 12½ percent of their share of the inventory each year. In only 1 year, however, approximately 51 percent of the inventory has either been delivered or placed upon purchase agreements.

And I might stop here to say that the proceeds from the sale of that 51 percent taken down results in over $500 million which will be transferred to the Commodity Credit Corporation's treasury.

Consequently, we are concerned about anything that would disrupt the delicate balance of our new program and the buy-out agreement. A major rise in cigarette excise taxes could jeopardize the progress we have made to restore stability to our program and profitability to our growers.

We are especially concerned at this time. Flue-cured growers will begin selling their crop later this month. As a matter of fact, on July 28. If Congress raises the cigarette excise tax now, then we perceive disruption of our markets.

Taxes on tobacco products represent 40 percent for sales and excise taxes, excluding local taxes, or 35 percent for excise taxes only, of total expenditures by consumers. This is already a big burden on one industry. And let me simply illustrate.

One tobacco plant averages 18 to 22 leaves. In 1986, a grower received an average of 50 cents for one tobacco plant and the leaves therefrom. The Federal excise tax generated from that one tobacco plant amounted to 86.4 cents based upon the current Federal tax of 16 cents per pack, plus 91.8 cents per plant, for the average State tax of 17 cents per pack, for a total of $1.78 per plant for State and Federal excise taxes, excluding local taxes.

To take this further. One acre of tobacco then generates $5,184 in Federal taxes, excise taxes alone, or $10,680 for State and Federal excise taxes, excluding local taxes. And while the grower receives just over $3,000 for one acre of tobacco before his expenses are deducted, the U.S. Government receives more than 3½ times the revenue per acre of tobacco than the farmer. And we feel we are taking more than our share of the tax burden.

Therefore, we are opposed to any increases in cigarette excise taxes.

Thank you very much.

Mr. RANGEL [presiding]. Thank you, Mr. Bond.

Mr. Midden, Council for Burley Tobacco.

STATEMENT OF G. BERNARD MIDDEN, JR., IMMEDIATE PAST PRESIDENT, COUNCIL FOR BURLEY TOBACCO

Mr. MIDDEN. Mr. Chairman, my name is G. Bernard Midden, Jr., representing the Council for Burley Tobacco.

The council is composed of approximately 200,000 burley tobacco growers, the major farm organizations in Kentucky, and other businesses associated in burley tobacco production.

I am a tobacco/livestock farmer from Harrison County, KY.

We are all aware of the many problems facing the tobacco industry today, particularly the excessive taxes placed on tobacco products.

There are those who advocate further increases in taxes on tobacco products.

I believe excise taxes are unfair taxes. When the excise tax was increased in 1982, the 55 million people who choose to smoke were singled out and a tax imposed on them. I think this is unequal and unfair taxation.

Farmers, particularly tobacco farmers, are in the worst economic crisis since the depression and excessive taxation is the major cause of the problem.

In 1982, Congress added an additional 8 cents per pack excise tax on cigarette, with the provision for this additional tax to expire in October 1985. As you know, the tax was continued, and now we have a 16 cent Federal excise tax a pack on cigarettes.

Following the imposition of this tax, cigarette consumption dropped by 6 percent. While other factors contributed to the decline in cigarette consumption, I am convinced that the additional excise tax was a major factor causing the decline.

The large decline in cigarette consumption impacted directly on farm income from tobacco. It is estimated that the value of the tobacco crop declined by $1 billion in 1983. Part of this decline was due to adverse weather, but a large part of the decline in farm income can be attributed to lower consumption of tobacco products caused by increased excise taxes.

During 1984 and 1985, all segments of the tobacco industry worked together to develop a tobacco program, designed to cope with the declining demand for tobacco products, excess supplies of tobacco in storage, and a declining U.S. share of the world market for tobacco.

If excise taxes on tobacco products are increased again, I believe that the demand for tobacco products will decrease, the amount of tobacco in storage will increase, our share of the world market for tobacco will decrease, and farm income to tobacco growers will decrease significantly. I therefore strongly recommend that you do not impose additional excise taxes on tobacco products.

According to Dr. Milton Shuffett, professor of agriculture economics at the University of Kentucky, if excise taxes on cigarettes were increased by 16 cents, for example, the results would be as follows:

One, the average U.S. price of cigarettes is about a dollar per pack. The 16-cent tax increase being discussed in Congress would be an increase of 16 percent.

No. 2, cigarette consumption would decline by 11.2 percent.

No. 3, Federal revenue from cigarette taxes would increase from $4,331 million collected in 1985–86 to $7,692 million.

No. 4, State tax collections on cigarettes would decline from $4,540 million collected in 1985–86 to $4,032 million , or a decline of $508 million.

No. 5, local excise taxes collected would decline from $199 million to $177 million, or a loss of $22 million.

No. 6, State sales tax on cigarettes would average about 5 percent, or 5 cents per pack. For the United States, these taxes total about $1,350 million. Reduction in these collections would amount to about $150 million.

No. 7, domestic use of burley usually runs about 425 million pounds, and most burley is used in cigarettes. Eighty-two percent of cigarettes are tax-paid withdrawals. Consequently, the need for

domestic burley would be expected to decline by about 9.2 percent or about 39 million pounds. The average price support level for the 1987 burley crop is $148.80 per 100 pounds. Therefore, this would mean a $58 million reduction in farm income from burley tobacco.

Total farm income from all tobacco is estimated at about $2.2 billion, and total tax revenues are about $9.5 billion. Tax revenues are more than four times greater than farm income from tobacco. Farm income from burley tobacco from burley tobacco dropped by 48 percent from 1984–86. Any further increase in excise taxes will reduce farm income from tobacco.

I appreciate the opportunity to express the position of the Council for Burley Tobacco on this important issue.

Thank you.

Mr. RANGEL. Thank you. Do we have any questions from members of the panel?

Mr. ANDREWS. Yes, I'd like to ask some questions, Mr. Chairman.

Mr. RANGEL. The Chair recognizes Mr. Andrews.

Mr. ANDREWS. Mr. Midden, if I could, let me direct some questions to you, please, sir. I was not able to hear the opening statements of all the witnesses, and I apologize for being late.

I'm curious. I have a statement here of the American College of Physicians that's prepared testimony, and I would like to ask you a few questions.

Is their statement accurate that approximately 350,000 Americans die prematurely each year because of illness caused by cigarette abuse? Do you think that number is accurate, sir?

Mr. MIDDEN. I don't know how they verify that number. I have doubts that it is true.

Mr. ANDREWS. What number do you think would be a realistic figure?

Mr. MIDDEN. I would not have any idea, sir.

Mr. ANDREWS. They further testified that cigarette smoking accounts for about 30 percent of the more than 40,000 cancer deaths annually in the United States.

Do you think that figure is accurate, sir?

Mr. MIDDEN. That is circumstantial evidence as far as I'm concerned. There's never been any proven link between smoking and cancer.

Mr. ANDREWS. Their group have also stated that the direct, not indirect, medical cause of smoking-related diseases are in excess of $23 billion annually. That was done by a study by former officials of the National Center for Health Statistics. This amounts to about 72 cents for each pack of cigarettes sold in the United States.

Do you think that statistic is accurate, sir?

Mr. MIDDEN. No, sir.

Mr. ANDREWS. What do you think would be a more accurate statistic or dollar value of the costs of smoking-related disease?

Mr. MIDDEN. I would not have any idea. But I think it is wrong to lay all these costs to cigarette smoking.

Mr. ANDREWS. The Office of Technology Assessment has estimated that of the total medical bill for smoking, the Federal Government paid about $4.2 billion in 1985 through Medicare, Medicaid and other health programs. We are in the process now of reviewing

those programs in terms of trying to bring our revenues and expenditures into line.

Do you think that statistic is accurate?

Mr. MIDDEN. I have no idea whether it would be or not. I could not say.

Mr. ANDREWS. Finally, it's my understanding that you testified—I thought I heard this when I came in, sir, that to increase the cost of a package of cigarettes would decrease consumption.

Is that an accurate assessment of what you said earlier today?

Mr. MIDDEN. Yes, sir.

Mr. ANDREWS. You are going to lose business if we raise the tax on cigarettes?

Mr. MIDDEN. Pardon me?

Mr. ANDREWS. You're going to lose business.

Mr. MIDDEN. Right.

Mr. ANDREWS. There are going to be people that aren't going to smoke.

Mr. MIDDEN. Yes, sir, that's correct.

Mr. ANDREWS. Of the people that take up smoking, it's estimated by this report that most of them are teenagers between the ages of 12 and 19 years old.

Do these statistics reflect the marketplace?

Mr. MIDDEN. I am not familiar with market figures, sir. If someone has estimated that, that could be correct, yes.

Mr. ANDREWS. Mr. Strauss, would you want to comment on the market studies, who the people are that use tobacco products?

Mr. STRAUSS. No, I don't believe that I, as a wholesale distributor and representing an organization of small business people have any expertise in this area. And I don't think it's appropriate for me to testify on that.

Mr. ANDREWS. Mr. Myers or Mr. Bond, would you care to comment on that statistic?

Mr. MYERS. Certainly. Every study that has been done indicates that those statistics are relatively accurate. The only thing that I would add to what you've said is that the data consistently shows that approximately 60 percent of those who start smoking are 14 years old or younger. That means when you talk about 12 to 19, you're missing the group of under 12. There is a very substantial percentage who start before they become teenagers.

Mr. ANDREWS. OK. So, within the brackets of people that take up smoking, about 90 percent are under 21, is that a fair statement?

Mr. MYERS. That's absolutely correct.

Mr. ANDREWS. A person 45 years of age is not likely to start smoking?

Mr. MYERS. That's absolutely correct. Usually no one starts after the age of 25.

Mr. ANDREWS. And of the 90 percent under 21, are most of those under 14?

Mr. MYERS. Fourteen and under, that's correct.

Mr. ANDREWS. Of the demographics groups in the country, which ones are increasing their smoking habits presently?

Mr. MYERS. It's not correct to speak in terms of increasing. It is correct to speak in terms of not reducing.

During the midseventies, we saw, for example, a dramatic rise in smoking among teenage girls. Currently there's no across-the-board population where smoking is increasing.

What we're finding though, however, is that among blacks, there is no dramatic decrease. They've held up at the high level they were at before.

The one area we do find an increase in certain pockets are Hispanics. For example, there was a study done in New Mexico not long ago that showed that very few Hispanics were smoking. Not surprisingly, not long after that, the tobacco industry introduced one or more cigarettes targeted specifically at that market, and smoking rates among that small group out there began to increase.

So what you're finding is that an increasing percentage of smokers do fall into the category of lower socioeconomic classes and, in many cases, among minorities because they have been increasingly targeted through marketing efforts.

Mr. ANDREWS. If these numbers in the report of the American College of Physicians are accurate or close to accurate, and approximately 350,000 people a year die as a result of smoking, that's about a thousand people a day of customers that you're losing. And so, in order to keep your market share just what it is today, you've got to find a thousand new people or so every day to take up the habit of smoking, buying your product.

Would you say that's correct, Mr. Strauss or Mr. Midden.

Mr. STRAUSS. My only comment on the issue is that it's my impression that all those people who are espousing an increase in excise taxes of consumer products are those people who want to use tax policy in the United States for a social purpose.

Mr. ANDREWS. Well, I appreciate your response, but that's really not responsive to my question.

My question is really just to see if we could draw a conclusion that we might agree on, if 350,000 people a year die as a result of smoking—at least that's what the American Cancer Society has testified to previously—then that means that you have to go out and find about a thousand new smokers every day just to keep your market share about what it is presently.

I assume others quit smoking and, therefore, you've got to go out and you've got to find a thousand new people that smoke every day. The point of my question is, if this testimony is believable or close to believable, the great majority of those thousand new smokers a day are going to be young children. They are going to be certainly under 20 years old, and more probably under 14. And they are probably more likely to be young teenage girls than teenage boys.

I'm curious. Would you agree with that assessment of the marketplace? That is your business, to sell. I'm not asking you to comment necessarily on the health risk, but if you lost 1,000 a day, just to keep your market share, don't you agree that you'd have to go out and attract about 1,000 new smokers every day to stay even?

Mr. STRAUSS. My business as a wholesale distributor of many different consumer products deals with the disappearance of people every day. And if I had to deal with specific marketing figures with respect to one or another product, I couldn't run my business.

I am running my business on a day-to-day basis, and if my market share declines, I do something to increase my market share, whether I buy my competitor, or do whatever is necessary to stay in business. I will stay in business.

I have no other comments about the statistics that the College of Physicians is broadcasting.

Mr. ANDREWS. Mr. Midden, do you feel qualified to respond to that question?

Mr. MIDDEN. Not totally, no, sir.

Your reasoning of logic is correct though. I would have to say that.

Mr. ANDREWS. Thank you very much.

Mr. MIDDEN. I don't know whether I like the word "attract smokers" or not, but if you're going to keep a market share, if you lose some, you're going to have to replace them. That is correct.

Mr. ANDREWS. Thank you very much.

Thank you, Mr. Chairman.

Mr. GUARINI [presiding]. Thank you.

We all recognize the health hazards that exist in cigarettes, but cigarettes and smoking are legal, are permissible under our laws, and what we have before us is the question as to what type of attacks would be best in the interest of our country right now to reduce our deficit.

And I would just like to ask you a few questions about excise taxes.

As I understand, there are some people who wish to have a progressive tax, that the tax be levied against the wealthier; that we had taken 6 million poor people off the tax rolls in the tax reform bill of last year; which segment of our population is going to bear the burden for making up for that budget deficit?

Now, we have $19.3 billion to raise. What would be the economic implications of an increased tax on cigarettes from an employment posture? If the cigarette industry and the gas industry and the beer and liquor industry were going to pay, they are going to take a considerable burden of these taxes, I would assume that there is bound to be some displacement of employment.

Do you have any statistics that would indicate the economic impact it would have on the farmers in the tobacco growing States?

Anybody. Mr. Midden?

Mr. MIDDEN. I think in my statement I stated that the decrease in burley tobacco sales and what impact it had on burley growers as a whole.

We have lost $58 million. We've had that much reduction in income.

Mr. GUARINI. Well, that's in income. I'm talking about employment. Would this affect the employment picture in some parts of our country?

Mr. MIDDEN. Yes, sir.

Mr. GUARINI. Would you describe what it would do?

Mr. MIDDEN. It would affect any of the tobacco producing areas.

Mr. GUARINI. Well, do you have any indication as to whether or not we would have an employment problem, or would there be the same number of tobacco growers and the same number of people employed in the business? Would a tax have any effect? Inasmuch

as cigarette smoking is habit forming, would you expect a decrease in consumption and a decrease in employment, or is there no correlation?

Mr. MIDDEN. I think there would be a correlation, yes, sir.

Mr. GUARINI. Do you have any studies in that regard?

Mr. MIDDEN. No, sir, I do not.

Mr. GUARINI. Anybody else wish to mention anything in that regard?

Mr. Myers?

Mr. MYERS. Actually, the data, as it relates to that, shows that the decrease in the number of the tobacco farmers began well before Congress increased the tax in 1982, and that the largest decrease in the number of tobacco farmers has in fact not come about as a result of consumption habits in this country, but has come about as a result of the decision of the five or six multinational manufacturers to purchase increasing amounts of their tobacco abroad. That's the primary reason for the decrease as you look at it over time, over the last decade.

Mr. GUARINI. You mean competition from overseas?

Mr. MYERS. Well, I mean this is different than the traditional competition from abroad because our manufacturers are fostering the growth of tobacco overseas so that they can bring it back in at cheaper rates than our farmers can sell it.

And that's had the greatest impact on those farmers over the past decade, substantially greater than anything that has come about as a result of the health efforts of the health community or the effect of the 1982 excise tax increase.

Mr. GUARINI. Yesterday, State and local government officials came forward and said that they depend on excise taxes on tobacco and gasoline, and would prefer that the Federal Government leave this preserve to them because they have fewer choices of raising money than the Federal Government does.

And I wondered whether or not you would comment on that?

Mr. STRAUSS. The data, and I'd be happy to present you a study that was done by Harvard after the 1982 tax showed that even though there was a decrease in consumption, we think an important one, that the excise tax collected by the State and local governments after that continued to increase so that the harm to them was not so substantial as to make it an either/or.

This is a product for which there is room for both the Federal Government to get back its fair share of the cost of smoking to the Federal Government, while State and local government do so on an individual need basis.

Mr. GUARINI. The Federal Government went in 1982 from 8 to 16 cents.

Mr. STRAUSS. Correct.

Mr. GUARINI. Is that same kind of track record found in most of our States, that they've been doubling the tax on cigarettes?

Mr. STRAUSS. The track record from the States varies very, very dramatically from State to State. Many of them had moved up their taxes dramatically before 1982. There has been some movement between 1982 and 1984, and less movement since that time. But one couldn't give an average State. It ranges from as low as

two cents in States like North Carolina, not surprisingly, to up to close to 32 cents in a few other States, but only a few.

Mr. GUARINI. What are the highest States, Mr. Myers?

Mr. MYERS. I would be happy to provide the committee with a full list for the record. I don't have it in front of me.

Mr. GUARINI. Would you, please?

Mr. MYERS. I'd be delighted to do that.

[The information from Mr. Myers follows:]

STATE CIGARETTE EXCISE TAXES

STATE	TAX PER PACK (CENTS)	STATE	TAX PER PACK (CENTS)
AL	16.5	MO	13
AK	16*	MT	16
AZ	15	NE	27*+
AR	21	NV	20+
CA	10	NH	17
CO	20	NJ	27*+
CT	26	NM	15*
DE	14	NY	21
DC	17+	NC	2
FL	24	ND	27+
GA	12	OH	18+
HI	**	OK	18
ID	18*+	OR	27
IL	20	PA	18
IN	15.5+	RI	25*
IA	26	SC	7
KS	24	SD	23
KY	3*	TN	13
LA	16*	TX	26++
ME	28	UT	23+
MD	13	VT	17
MA	26*	VA	2.5
MI	21	WA	31
MN	38*+	WV	17
MS	18	WI	30+
		WY	8

*Portions of tax earmarked to health and cancer-related programs.
**Hawaii tax is 40 percent of wholesale price.
+Increased in 1987.
++Increased in 1988.

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Mr. STRAUSS. I'd like to respond to your employment question, Mr. Guarini.

Mr. GUARINI. Yes, Mr. Strauss.

Mr. STRAUSS. I think history is our best teacher. In the 1982 scenario where the excise tax was doubled, the lost jobs in the industry were over 14,000 in both manufacturing and distribution.

Mr. GUARINI. I'm sorry, sir. I was distracted.

Would you please repeat that statement?

Mr. STRAUSS. In the scenario in 1982, immediately when the excise tax was voted on to be doubled, effective 1983, the first of January 1983, during that period of time, or right after the doubling, the reduction in cigarette consumption resulted in over 14,000 jobs lost in manufacturing and distribution.

Mr. GUARINI. Where were they mostly lost? On the farm, or in manufacturing?

Mr. STRAUSS. This does not include the farm. I don't have any figures on the farm.

Mr. GUARINI. So it's mostly in the production?

Mr. STRAUSS. No——

Mr. GUARINI. Not in the growing of the tobacco?

Mr. STRAUSS. This doesn't include the retail either. Actually most of the figures came in distribution, wholesale distributors.

Mr. GUARINI. Our country subsidizes tobacco growers as part of our agricultural system.

What States are hit the most? And can you describe what the situation is among farmers in the tobacco industry in the Southern States?

Mr. STRAUSS. I have no knowledge of the farming situation.

Mr. GUARINI. Would anybody be able to address that?

Mr. BOND. Yes, sir. Did I understand you to say that tobacco growers are subsidized?

Mr. GUARINI. Yes. I understand they are.

Mr. BOND. They are not. They are not.

Mr. GUARINI. Well, I understand that there are tobacco laws that we have that favor the tobacco farmer in the producing of the tobacco leaf.

Now, if you tell me to the contrary, I'll go back to the books. But I understood that there were some very immediate questions as to whether one part of our Government, when Mr. Califano was Secretary of HEW, at that time had a budget to stop people from smoking. And then we had another budget to help farmers to grow the tobacco. And the question has been created.

Mr. BOND. May I comment. I explained that in my testimony, that in 1982, the Congress of this country eliminated tobacco farmers for participating in farm programs. The only opportunity we have to participate is to borrow money from the Commodity Credit Corporation to assure our growers of a fair price in the market.

Mr. GUARINI. Well, that's a form of subsidization; you get low-interest rates.

Mr. BOND. Let me complete that. Once that process is completed, the loan is made, the tobacco is taken as collateral. This tobacco is sold. We must guarantee repayment of every dime of principal plus the going rate of interest to Commodity Credit, USDA.

Mr. GUARINI. Do you get special low-interest rates?

Mr. BOND. We pay the same rate that all other commodities pay on their loan.

Mr. GUARINI. What the farmers get, yes.

Mr. BOND. Yes. Now, this is done by going into the farmer's pocket to assess him on every pound of tobacco. It's paid into a fund to make sure that we repay everything that we borrowed plus the interest. So there is no subsidy to tobacco growers.

Mr. GUARINI. What is the track record, Mr. Myers?

Mr. MYERS. Unfortunately, the track record has not been good. There have been hidden costs, but there are some not so hidden costs as well.

First, you were correct, that it's estimated that it costs in excess of $15 million a year to administer this system, which is a form of subsidy.

Second, although the interest rates have been moved up to competitive interest rates, the manner in which they're calculated has led to large-scale losses, many of which have been documented.

Third, the no-net-cost program was instituted in 1982. The farmers came back to Congress in 1986, saying that the no-net-cost program was costing them so much money that they asked Congress for a bailout. Thus, that last year Congress enacted a $1 billion bailout for the allegedly no-net-cost tobacco program.

So the no-net-cost tobacco program has cost us a very substantial amount of money despite its title and despite the premise upon which it was created.

Mr. GUARINI. Is there any comment on that?

Mr. BOND. Excuse me. I'm not going to debate with the gentleman here, but he's wrong in his figures, and we'll be glad to supply you with the figures.

Mr. GUARINI. Will you get closer to the microphone?

Mr. BOND. I said I'm not going to get into an argument here with the gentleman. We did in the hearings before.

I question his figures, the validity of his figures as he just related to you. And I won't take the time to go into the matter. I don't even have them but I'll be glad to supply them to you.

Mr. GUARINI. Well, the record will be left open so that you can add your statement, and we will appreciate it.

[The following was subsequently received:]

Congress passed legislation in 1982 requiring that the tobacco program be operated at No Net Cost to the taxpayers. Beginning in 1982, growers were assessed an amount on each pound of tobacco marketed to insure no cost to the Government. The only loss to the Government since 1982 was authorized by congressional action in 1986. The loss was due to severe and extreme drought conditions that was devastating to the quality of the 1983 burley crop of tobacco. As a result, the Burley Cooperative received substantial quantities of the 1983 crop (over 200 million pounds) at a cost of over $600 million. The estimated loss to CCC is $373 million, substantially less than the losses indicated by Mr. Myers.

Mr. BOND. This billion dollar loss is absolutely incorrect.

Mr. GUARINI. All right. Thank you. Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman. Mr. Bond, is the administration of the program paid for by Federal funds?

Mr. BOND. The administration of the program from the Washington level, from the county office level where there are people there anyway, is not included in the no net cost legislation. That money would be spent, more than likely anyway, because of the existing

employees that are already out in these counties across the Southeast.

And may I say one thing here: tobacco growers are human beings. They are people. They have been growing tobacco 400 years. Now why is it so wrong for a tobacco farmer not to enjoy the benefits of farm programs provided to other commodity groups?

These are people we are talking about. They are not numbers. This is simply unfair.

Mr. PEASE. Mr. Bond, other people may or may not be unfair, but I am not asking the question in a hostile manner. I am trying to seek information.

Mr. BOND. Yes.

Mr. PEASE. I had heard a couple of years ago from my friends—and I would emphasize friends—from North Carolina, that after that program was set up, the cost of paying back the loans was becoming prohibitive. That the farmers who were being assessed were going to have to face a very high assessment because the market price of tobacco had dropped, and there was a real question in their minds as to whether this system of assessments to pay for the loans would be able to be sustained.

Now, has there been any change in that situation?

Mr. BOND. Yes, sir. That was a terrible financial burden on our producers in 1982 through 1984. As a matter of fact the assessment in 1985 had grown to 25 cents a pound. That was because of the excessive tobaccos going into our association, 500 to 600 million pounds at a billion dollar cost, and we had to underwrite that billion dollars through assessments.

They could not live. They would have gone bankrupt. So, in 1986, there were modifications made in the program. The price support was reduced. I think we are more competitive in the world market today.

As I say, our assessment this year for the grower is only 2 cents, so the program has worked, this burden has been lifted.

Mr. PEASE. Do I recall correctly, that the law was changed to impose the burden on cigarette manufacturers rather than farmers?

Mr. BOND. Well, in the 1986 legislation, there was an authorization to purchase, and the companies had agreed to purchase our prior stock from 1976, as a matter of fact, through 1984, over 580 million pounds of tobacco. And they bought that tobacco, and the value of that purchase was $1.2 billion. Every dime from those sales, once they are completed, will be turned over to the U.S. Treasury.

Now that is the mechanism under which we got the assessment from 25 cents a pound to 2 cents a pound.

Mr. PEASE. Two cents a pound covers current production, is that right?

Mr. BOND. Two cents a pound is the figure that growers pay. Manufacturers and buyers pay an equal amount of 2 cents. So there is an assessment collected from buyers and producers, of 4 cents, to underwrite the crops now in inventory and the projected receipts from the 1987 crop.

Mr. PEASE. I see. Thank you. Mr. Strauss, I was interested in your statistics which showed that cigarette taxes have gone up

faster than the CPI over a period of time. Is that what you testified?

Mr. STRAUSS. That is the aggregate total of the Federal, State, and local taxes on cigarettes.

Mr. PEASE. I was interested that Mr. Myers, I believe it was, gave us testimony which said that the cigarette tax, as a percentage of the retail price, has gone down in the last 30 years. Is that right? Mr. Myers, did your figures include Federal tax only, or Federal, State, and local?

Mr. MYERS. Now I gave you different figures. I gave you Federal tax figures as it relates to CPI. I gave you Federal, State, and local tax figures as it relates to percentage of the pack of cigarettes.

And so you are quoting me correctly. The percentage of tax on a total pack of cigarettes has dropped by fully a third over the last 20 years.

Mr. PEASE. And that is State, Federal, and local?

Mr. MYERS. That is correct.

Mr. STRAUSS. Those are average figures, and I am not attesting to the accuracy of those figures. I can only tell you that in my territory in my business, the taxes—which is New York, New Jersey—the taxes on a pack of cigarettes today are fully 44 percent of the price of a pack of cigarettes.

Mr. PEASE. Thank you. One final question for Mr. Myers. Last year, when we, in this committee, worked on tax reform, a guiding principle of tax reform was that we ought to use the Tax Code to raise revenue, not to influence social and economic behavior. And we, in the process of tax reform, cut away a lot of taxes and were encouraging people to buy homes and drill oil wells, and all that sort of thing.

And I guess I am a little troubled that your proposal was counter to that theory. Also, you talked about the regressivity, or made some points arguing against the regressivity argument.

But isn't it true, that for those people who have been smoking, and are smoking, and will continue to smoke—that is, the people who are hooked on cigarettes, that for those people a cigarette tax increase would be highly regressive?

Mr. MYERS. Let me address each of your questions as briefly as I can. In a small respect what we are recommending does run counter to the notion that tax policy should have no impact on behavior whatsoever.

However, it is also a reality that all tax policy has some impact on behavior. In this case we have a unique product, a product which is the only product in our Nation which, when used as intended, kills, and perhaps even more importantly, kills 350,000 Americans a year.

The numbers pale in comparison to anything else. So that it makes good sense, not in terms of what we want in terms of social behavior or moral behavior, but in terms of pure health policy, to be doing whatever we can to discourage the use of tobacco, particularly when we know that this policy will affect people by causing them not to start, and that is what we do know.

The second question you raise is the one that I said is the most serious, and the one that concerns us the most, and that is the

impact of any excise tax, but particularly this one, on poor people who smoke. It will have an impact, there is no question about that.

However, we know a couple of things. That minorities and the poor tend to smoke less, even though a greater percentage of them smoke. So that when you calculate at the rates they smoke, this will cost them less than a dollar a week if you increase the tax by 16 cents. That is real money for them. I am not downplaying the importance of that, but I am saying we need to keep it in perspective.

Second, if in fact we are right, that it is going to result in dramatically decreased smoking rates among their children, their household income, both from not diverting the money to cigarettes and from decreased health-care costs, will make them better off, economically, both in the short term and the long term. So that that is a critical question.

Let me also just very briefly address—you asked Mr. Bond a couple questions which, in two sentences, I would like to answer. Your first one is does the Federal Government pay for the administration of that program, and the simple answer to it is yes.

The second question was, what was the effect of the 1986 program change. Mr. Bond is correct. The 1986 program change worked out a system to permit the manufacturers to buy the excess tobacco. What he did not tell you was that the manufacturers were permitted to purchase this tobacco at enormous discounts from the price that the American taxpayer purchased the tobacco, which is why the Government estimated that it would result in substantial cost to us—you and I—the American taxpayer.

Mr. PEASE. Thank you very much.

Mr. GUARINI. Are you finished? Any further questions?

Mr. PEASE. No, Mr. Chairman.

Mr. GUARINI. The query we have is whether or not we should use our Tax Code to change behavior, and I guess that is something that will be debated by the committee itself. But it is quite clear, from what I can understand, that the tax would be raised basically from the poor, and those that can least afford it, rather than from the wealthy, so it is not a progressive kind of a tax.

Can you tell me whether or not there is any economic recession in any segment of this industry? Is the industry, as a whole, a fairly healthy industry?

Mr. MYERS. Cigarette manufacturing is one of the most profitable industries in this Nation at this point in time.

Mr. GUARINI. So that there is no hardship in the industry at all if——

Mr. STRAUSS. That is not true. The cigarette distribution, wholesale distribution industry is deteriorating at an alarming rate, losing members every year. The gross profit margins of our industry are continually declining, and we are becoming less and less competitive in the marketplace.

Mr. GUARINI. Can you tell me what happened when an 8-cent tax was put on cigarettes in 1982. How much did that mean in the cost to the consumer? As I understand it, the manufacturers and distributors do not necessarily add just the tax, but they add profit on top of the tax.

Has there been an experience base as to what happened when the Government put an 8 cent tax on cigarettes in 1982, as to what the price was in the machine or over the counter?

Mr. STRAUSS. Well, the 80 cents a carton or 8 cents a pack increase effective in the first of 1983, which was gradually put on at the wholesale level, and at the retail level between August of 1982 and January of 1983, also coincided with a period of time when the manufacturers would have normally raised their prices as well.

The result, from the time the tax was enacted to the time the time of the effective date was about $1.14 a carton versus 80 cents a carton on the tax rate. So it was 34 cents above the increase in the tax.

Mr. GUARINI. That is traditional on gasoline tax or any excise taxes, that the distributor, or retailer adds more than the tax, but even puts an additional profit on top of the tax?

Mr. STRAUSS. It is usually that the manufacturer does and the retailer does. The wholesaler generally has no opportunity to do so.

Mr. GUARINI. Okay. Thank you. I want to thank the panel very much. You have been very helpful. I would like to ask the Jewelry Coordinating Committee, Robert Leeds, president of Jewelmont Corp., Minneapolis, MN, and the National Marine Manufacturers Association, Jeff Napier, executive director to come forward. Also, the Cellular Telecommunications Industry Association, Richard C. Notebaert, member of the board of directors.

The United States Telephone Association, Bennet Miller, president, and, the National Telephone Cooperative Association, Fredric J. Ziegler, director of financial analysis, from Texas, if you will please come forward.

If any of you gentlemen who just testified, for which the Chair thanks you, wish to add any additional information to the record, we would be very happy to receive it and place it into the record.

As soon as you gentlemen get started, any statement you wish to enter into the record will be made a part of the record. I would appreciate it if you would give us a summary of your remarks, and we will start with Mr. Robert Leeds, the president of Jewelmont Corp.

Mr. Leeds, we welcome you.

STATEMENT OF ROBERT LEEDS, PRESIDENT, JEWELMONT CORP., MINNEAPOLIS, MN, ON BEHALF OF JEWELRY COORDINATING COMMITTEE, INC., ACCOMPANIED BY MATTHEW RUNCI, EXECUTIVE DIRECTOR, MANUFACTURING JEWELERS & SILVERSMITHS OF AMERICA, INC.

Mr. LEEDS. Mr. Chairman, I am Robert Leeds, president of Jewelmont Corp. On my right is Mr. Matthew Runci, executive director of the Manufacturing Jewelers & Silversmiths of America, Inc.

Jewelmont Corp. is a manufacturer of moderately priced jewelry in Minneapolis, MN. My testimony today is on behalf of the Jewelry Coordinating Committee, Inc., an industry group representing 12,000 retailers, and 2,400 manufacturers employing over 150,000 people in 50 States.

Members of the committee include the Manufacturing Jewelers & Silversmiths of America, Inc., Jewelers of America, Inc., Ameri-

can Watch Association; American Gem Trade Association; and the Writing Instrument Manufacturers Association.

I am here today to present the industry's position on a proposed 10 percent excise tax on jewelry. Selective retail excise taxes, including those on jewelry, were imposed as temporary emergency wartime measures in early 1940's, as a means to divert unnecessary expenditures and to supplement necessary wartime revenues.

However, these so-called temporary taxes were not repealed until June 1965. At that time, this committee's report set forth among others, the following reasons for repeal:

> A selective system of excise taxes places discriminatory tax burdens on the consumers and producers of the taxed products.
>
> Selective excise taxes tend to reduce sales and therefore reduce incomes and jobs in the industries which produce the taxed goods.

What was true 20 years ago is still true today.

The following are the current views of the jewelry industry as to why an excise tax on jewelry should not be imposed.

As a selective Federal excise tax, a retail tax on jewelry will cause distortions in buying patterns and will be highly discriminatory against one industry. The tax will discourage the purchases of jewelry in favor of other untaxed articles of a comparable value and desirability.

Imposing a selective excise tax on jewelry would unfairly discriminate against the jewelry industry, especially since so many true luxury items would not be taxed.

In addition, there is no need to discourage the consumption of jewelry at this time. There are no shortages of materials used to make these products, nor is there a pressing national security need to be satisfied. There are no social costs associated with the consumption of jewelry, so there are no sumptuary purposes to be met.

The old-fashioned luxury argument for an excise tax on jewelry is far out of date. Jewelry is not monopolized by the rich. For example, in 1986, 49 percent of the gold jewelry purchased in the United States was by households with incomes of less than $30,000. Only 17 percent was purchased by households over $50,000. Rising incomes have made the preponderant majority of jewelry common consumer items.

Also, if the idea of a so-called luxury tax is to solve some of the distributional problems created by the inherent regressive nature of excise taxes in general, it should be kept in mind that jewelry is bought by purchasers in all income brackets.

The impact of this tax will, in large part, fall on the very same people who purchase other items such as cigarettes, liquor, and beer, which are also being considered for excise tax increases, and not necessarily on upper income purchasers.

An excise tax on jewelry would depress an already depressed industry. Since the excise tax will be passed on in most instances to retail purchasers, sales will be reduced. This will cause reduced production by manufacturers which will result in a further decline in employment in an industry which has lost over 15 percent of its work force over the past 10 years.

It is particularly ironic that at a time when this industry is staging somewhat of a comeback because of the effects of the weaker

dollar, that Congress would be considering levying a retail excise tax that could neutralize those gains.

Imports now account for one-third of the U.S. market for precious metal and costume jewelry. This is up 450 percent in 10 years. During that time, retail sales have generally been flat.

A 10-percent excise tax, which we believe would reduce overall sales, could accelerate imports as retailers look for ways to cut cost in order to maintain sales.

Imports have practically eliminated the domestic watchmaking industry, and have seriously crippled the gold and silver flatware and holloware industry. Does Congress intend that the same thing happen to the precious metal and costume jewelry manufacturing industry?

Any such excise tax would create major administrative and compliance costs. The burdens of collection, recording and transmitting this tax would fall on the shoulders of thousands of retail establishments which would be required to collect the tax on millions of transactions.

Such burdens would be relatively heavier for the small as opposed to the larger retail outlet. In its report on the 1965 legislation, this committee stated:

> In all, it is believed that 100,000 to 200,000 retail outlets are involved in the collection of this tax. The compliance burden imposed by the tax is often a severe one in an industry which contains a large number of small, one-family concerns.

Introduction of any threshold level would further complicate these administrative chores, and simultaneously opens wider possible avenues for tax avoidance, not because of dishonesty, but primarily as a consequence of the prevailing market pressures to keep prices as low and as attractive as possible to the potential customer.

A tax with a dollar threshold would result in widespread legal but uneconomic methods of avoidance. For example, earrings could be sold one at a time on separate days. Silver flatware could be divided up in to several purchases just under the limit. It would be foolish for the Federal Government, by this tax policy, to force this type of uneconomic consumer activity.

To assure that this tax avoidance is held to a minimum, the Federal Government would have to engage in a fairly vigorous audit and enforcement program. In turn, this would sharply increase the compliance cost to the Government. The experience in this, and other countries, has clearly indicated that the high levels of these costs are major disadvantages to the use of excise taxes.

It is not too difficult to foresee, the cost and confusion on the part of the consumer, the retailer, and the Internal Revenue Service. I trust that you agree with me, that this administrative morass is unnecessary.

To sum it up, there appears to be little merit in a 10 percent retail excise tax on jewelry sales beyond its ready accessibility as an easy target for a tax. Thus, any proposed retail excise tax on jewelry should be rejected. It is very bad tax policy. It will cause economic distortions in the consumer market. It is highly discriminatory. It will be costly to administer, both to the Government and the industry. It will produce a relatively small amount of revenue.

It will depress an already depressed industry. It would be a return to a tax which experts for decades have universally agreed was bad tax policy, and, for that reason alone, should not be reimposed. Thank you.

[The statement of Mr. Leeds follows:]

HEARINGS ON REVENUE INCREASE OPTIONS
BEFORE HOUSE WAYS AND MEANS COMMITTEE

Testimony of Robert Leeds
on Behalf of
Jewelry Coordinating Committee, Inc.
July 9, 1987

I am Robert Leeds, president of Jewelmont Corporation, a manufacturer of moderately priced jewelry articles in Minneapolis, Minnesota. My testimony today is on behalf of the Jewelry Coordinating Committee, Inc., an industry group representing 12,000 retailers and 2,400 manufacturers employing over 150,000 people in all 50 states. Members of the Committee include the Manufacturing Jewelers and Silversmiths of America, Inc.; Jewelers of America, Inc.; American Watch Association; America Gem Trade Association; and the Writing Instrument Manufacturers Association.

I am here today to present the industry's position on a proposed 10 percent excise tax on jewelry (including precious metal and costume jewelry), various precious and semi-precious stones, watches, clocks, sterling silver, and silver-plated, gold or gold-plated holloware and flatware. All these items will be referred to collectively as "jewelry" in this testimony.

Selective retail excise taxes (including those on jewelry) were imposed as temporary, emergency wartime measures in the early 1940's as a means to divert unnecessary expenditures and to supplement necessary wartime revenues. However, these so-called "temporary" taxes were not repealed until June 1965.

At that time this Committee's Report set forth among others, the following reasons for repeal:

- A selective system of excise taxes places discriminatory tax burdens on the consumers and producers of the taxed products.

- Selective excise taxes tend to reduce sales and therefore reduce incomes and jobs in the industries which produce the taxed goods. H.R. Rept. No. 433, 89th Cong., 1st Sess. 9 (1965).

What was true twenty years ago is still true today.

Your Committee files are replete with carefully prepared economic studies detailing the inequities and distortions created by such taxes on the distribution of affected products, the adverse effects on industry employment, the problems associated with compliance, and the questionable cost effectiveness of enforcement.

The following are the current views of the jewelry industry as to why an excise tax on jewelry should not be reimposed.

ECONOMIC DISTORTIONS AND DISCRIMINATION

As a selective federal excise tax, a retail tax on jewelry will cause distortions in buying patterns and will be highly discriminatory against one industry. The tax will discourage the purchases of jewelry in favor of other untaxed

articles of a comparable value and desirability. Imposing a selective excise tax on jewelry would unfairly discriminate against the jewelry industry, especially since so many true "luxury" items would not be taxed.

In addition, there is no need,to discourage the consumption of jewelry at this time. There are no shortages of the materials used to make these products, nor is there a pressing national security need to be satisfied that would otherwise go unfilled in the absence of the tax. There are no social costs or externalities associated with the consumption of precious jewelry, so there are no sumptuary purposes to be met.

The old-fashioned "luxury" argument for an excise tax on jewelry is far out of date. Jewelry is not monopolized by the rich. For example, in 1986 49 percent of the gold jewelry purchased in the U.S. was by households with incomes of less than $30 thousand; only 17 percent was purchased by households over $50 thousand. Rising incomes have made the preponderant majority of jewelry items common consumer items. Further, most reasonably priced jewelry articles are not normally perceived in the luxury category.

Also, if the idea of a so-called "luxury" tax is to solve some of the distributional problems created by the inherent regressive nature of excise taxes in general, it should be kept in mind that jewelry is bought by purchasers in all income brackets. The impact of this tax will, in large part, fall on the very same people who purchase other items such as cigarettes, liquor and beer which are also being considered for excise tax increases, and not necessarily on upper income purchasers.

EFFECTS ON A DEPRESSED INDUSTRY

An excise tax on jewelry would depress an already depressed industry. Since the excise tax will be passed on in most instances to retail purchasers, sales will be reduced. This will cause reduced production by manufacturers which will result in a further decline in employment in an industry which has lost over 15 percent of its workforce over the past 10 years. It is particularly ironic that at a time when this industry is staging somewhat of a comeback because of the effects of the weaker dollar, the Congress would be considering levying a retail excise tax that could neutralize those gains.

Imports now account for one-third of the U.S. market for precious metal and costume jewelry. This is up about 450 percent in ten years. During that time, retail sales have generally been flat. A 10 percent excise tax, which we believe would reduce overall sales, could accelerate imports as retailers look for ways to cut costs in order to maintain sales. Imports have practically eliminated the domestic watchmaking industry and have seriously crippled the gold and silver flatware and holloware industry. Does Congress intend that the same thing happen to the precious metal and costume jewelry manufacturing industry?

COSTLY TO ADMINISTER

Any such excise tax would create major administrative and compliance costs. The burdens of collection, recording and transmitting this tax would fall on the shoulders of thousands of retail establishments which would be required to collect the

tax on millions of transactions. Such burdens would be relatively heavier for the small, as opposed to the larger, retail outlet. In its report on the 1965 legislation, this Committee stated:

> In all, it is believed that 100,000 to 200,000 retail outlets are involved in the collection of this tax. The compliance burden imposed by the tax is often a severe one in an industry which contains a large number of small, one-family concerns. Moreover, there are difficult problems in determining actual sales price in the auditing of these returns. H.R. Rept. No. 433, 89th Cong., 1st Sess. 16 (1965).

Introduction of any threshold level would further complicate these administrative chores and simultaneously opens wider possible avenues for tax avoidance, not because of dishonesty, but primarily as a consequence of the prevailing market pressures to keep prices as low and as attractive as possible to the potential consumer.

A tax with a dollar threshold would result in widespread, legal but uneconomic methods of avoidance. For example, earrings could be sold one at a time on separate days. Silver flatware could be divided up into several purchases just under the limit. It would be foolish for the federal government by tax policy to force this type of uneconomic consumer activity.

To assure that this tax avoidance is held to a minimum, the federal government would have to engage in a fairly vigorous audit and enforcement program. In turn, this would sharply increase the compliance costs to the government. Experience in this and other countries has clearly indicated that the high levels of these costs are major disadvantages to the use of excise taxes. It is not too difficult to foresee the cost and confusion on the part of the consumer, the retailer, and the Internal Revenue Service to achieve some sense and order out of this entire excise tax area. I trust that you agree with me that this administrative morass is unnecessary.

SUMMARY

To sum up, there appears to be little merit in a ten percent retail excise tax on jewelry sales beyond its ready accessibility as an easy target for a tax. Thus, any proposed retail excise tax on jewelry should be rejected. It is very bad tax policy. It will cause economic distortions in the consumer market. It is highly discriminatory. It will be costly to administer, both to the government and the industry. It will produce a relatively small amount of revenue. It will depress an already depressed industry. It would be a return to a tax which experts for decades have universally agreed was bad tax policy, and for that reason alone should not be reimposed.

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Mr. GUARINI. Thank you, Mr. Leeds. Mr. Jeff Napier, executive director of the National Marine Manufacturers Association.

STATEMENT OF JEFF W. NAPIER, EXECUTIVE DIRECTOR, NATIONAL MARINE MANUFACTURERS ASSOCIATION

Mr. NAPIER. Thank you, Mr. Chairman. I am Jeff Napier, president of the National Marine Manufacturers Association, the NMMA.

NMMA is a trade association with over 1,300 members that manufacture recreational boats of all sizes and prices, marine engines, trailers and accessories, such as lifesaving gear and electronic equipment, as well as related products.

Our members are found in virtually every State. They range in size from sole proprietorships to businesses with hundreds of employees. Boat building itself is a labor-intensive process with much hand assembly required by semiskilled and skilled workers.

There are approximately 600,000 jobs involved directly, and indirectly, in recreational boating. My main message, Mr. Chairman, is that a 10 percent excise tax on boats over $15,000 in value might raise $100 million in excise taxes, but it would lose an equal amount in Federal income taxes as manufacturers' sales and profitability plummet, and employment in the industry drops suddenly and significantly.

The reason is simple. There is a high elasticity of demand for our products. Our pricing studies have shown that over the years, our elasticity is a two to one factor. Sales go down by 2 percent for every 1 percent increase in price, whenever prices go up faster than the overall inflation rate.

Thus, a 10-percent excise tax would likely reduce industry sales 20 percent. That much of a sales drop wipes out profitability, taxable profits, until fixed costs can be cut back and labor cut back. The laidoff labor will not, of course, continue to pay individual income taxes, but will instead consume Government funds in the form of unemployment compensation, welfare, and other programs.

We estimate a 10-percent Federal excise tax would produce an immediate loss of 20,000 jobs at the manufacturing end as a result of the depressed sales. This is in effect the labor component of a 20-percent sales drop. The counterproductive effect of the proposed excise tax is not a theoretical suggestion on my part.

There is direct evidence on the subject. In 1975, the British Labor Government imposed a 25-percent luxury tax on British boating products. Sales plummeted immediately by one-third, and the industry, which had been successful to that point, went into a deep depression. Thousands were laid off and Government revenues actually dropped.

Because of the devastating effects the tax was reduced 4 years later to 15 percent, but it took the British boating industry 11 years, until 1986, to get back up to the sales and employment levels that existed before the tax was imposed.

Great Britain is now considering the elimination of the luxury tax, totally, to stimulate sales, employment, and Government revenues, and the unhappy experiment has really come full cycle in Great Britain.

We have our own experience in the States with the volatility of the boating market. In 1980, President Carter's administration proposed a standby weekend boating ban as a symbolic energy conservation measure. Although the measure was only proposed, and withdrawn less than 180 days later, our sales were stopped dead in the water.

Forty percent of our sales, and 50,000 jobs were lost at the manufacturing end of the industry in those 6 months. Many businesses went bankrupt, bank loans were unpaid, and tax revenues from our industry went way down. In a lot of ways we were victims of our own Government.

NMMA believes the Congress acted correctly in 1965 when it eliminated virtually all then-existing excise taxes. The legislative history is quite clear that the Congress believed excise taxes enacted as emergency measures during wartime and depression were a drag on the economy and discriminated among products.

The imposition of excise taxes now on recreational boating would forget the lessons learned 20 years ago.

A similar discriminatory economic effect on boating manufacturers and customers would result from the proposed elimination of the qualified residents' interest deduction for boats. Not only is the proposal unfair, according to the Joint Committee estimates the elimination would raise very little revenue, less than $50 million.

The motivation for this proposal appears to be based on a misperception of who owns boats. In fact, boats are owned by the middle class. The proposed elimination not only discriminates among recreational housing choices, but hits the often less expensive alternative the hardest. How many second homes are there in States like Florida, Colorado, Texas, and California, not to mention Wisconsin, Michigan, and Minnesota? There are, clearly, tens of thousands.

Probably most are located on or near the beach, a lake, or in the mountains where people either retire, or enjoy recreation at their second home. Many are quite modest, indeed, and some are very luxurious and large. Most fall in between.

Their numbers are clearly in the millions, and within these millions, a minority are mobile second homes such as motor homes and boats. We do know that boats, as second homes, compete with other types of second homes in the marketplace. In general, a boat which has the habitable features required to be a second home for tax purposes, is cheaper than purchasing real estate and erecting a structure for the same second home purpose. You cannot get much of a cabin on a wooded lot, or on the beach, for $15,000, or $20,000, or even $50,000, but you can buy three-quarters of all so-called habitable boats for those prices.

The boat as a second home is very much a middle-class phenomenon. It is, for many families, the affordable alternative to second homes that involve real estate. With the philosophical commitment to progressivity in our Tax Code, it would be highly inequitable, not to mention unpopular, to take away the interest deduction for the less expensive second home choice of the middle class alone, without eliminating it for all second homes. And if the interest deduction for all of second homes is eliminated, their sheer number would suggest a widespread negative economic impact.

We would support, Mr. Chairman, broad-based taxes since they are both fairer and likely to generate the needed revenue. For example, we would support a $5 per-barrel-oil import fee and/or an increase in the Federal gas tax, and similar measures.

Thank you for letting me present our views.

[The statement of Mr. Napier follows:]

July 9, 1987

TESTIMONY

Jeff W. Napier, President

National Marine Manufacturers Association

I am Jeff Napier, President of the National Marine Manufacturers Association, the NMMA. NMMA is a trade association with over 1,300 members that manufacture recreational boats of all sizes and prices, marine engines, trailers, and accessories such as life saving gear, and electronic equipment, as well as related products. Our members are found in practically every state. They range in size from sole proprietorships to businesses with hundreds of employees. Boat-building itself is a labor-intensive process with much hand assembly required by semi-skilled and skilled workers. There are approximately 600,000 jobs involved in recreational boating.

Recreational boating activity may occur anywhere there is water, including, of course, the nearby Potomac River. The list of the top ten boating states, by distribution of registered boats, may surprise those who think of boating as purely an Atlantic or Pacific coast activity. The top ten states are Michigan, Minnesota, California, Texas, Florida, Wisconsin, Ohio, New York, Arkansas, and Louisiana, with Illinois a close eleventh.

Our customer base is equally broad and diverse. We estimate that over 68 million people participate in recreational boating. Recreational boating has many forms including skiing, fishing, camping, cruising, and sailing to name a few. Our typical customer, particularly the first time buyer, is a married male with a working spouse with children at home. Boat owners come from all walks of life, including government employees, teachers and retired persons, with most first time buyers categorizing themselves as workers or managers. Fully 70% of our customers make less than $60,000 a year. None are listed as "fat cats." Yet, that is the image that many critics of this industry conjure up. It is simply untrue and is a major reason why the proposed 10% excise tax is unfair, ill-advised, and bad public policy.

In sum, Mr. Chairman, a ten percent excise tax on boats over $15,000 in value, while likely to raise $100 million in excise taxes in the first year, would alos lose an equal amount in federal income taxes as manufacturers' sales and profitability plummet and employment drops suddenly and significantly.

The reason is simple. There is a high elasticity of demand for our products. Our pricing studies have shown that, over the years, our elasticity is a two-to-one factor--sales go down two percent for every one percent increase in price--whenever prices go up faster than the overall inflation rate. Thus, a ten percent excise tax will likely reduce industry sales twenty percent. That much of a sales reduction wipes out profitability--taxable profits--until fixed costs can be cut back and labor cut back. The laid-off labor will not, of course, continue to pay individual income taxes but will, instead, consume government funds in the form of unemployment and other programs. We estimate a ten percent federal excise tax would produce a loss of as much as twenty-thousand jobs as a result of the depressed sales.

Our product is a discretionary purchase: boating is among the first expenditures to be cut or postponed in the face of adverse economic circumstances. Recreational boating purchases are quite sensitive to interest rates, fuel availability, and general economic conditions. A 10% excise would be a substantial blow at a time when the industry is only now rebounding from fuel crises, high interest rates, and a depressed economy in the early 80's.

ounterproductive effect of the proposed excise tax is not a retical suggestion on my part. There is direct evidence on subject.

1975, the British Labor Government imposed a twenty-five ercent luxury tax on British boating products. Sales plummeted y one-third and the industry, successful to that point, went into a deep depression. Thousands were laid-off. Government revenues dropped.

Because of the devastating effects, the tax was reduced four years later to fifteen percent. But it took the boating industry eleven years until 1986 to get back up to sales and employment levels that existed before the tax was imposed. Great Britain is now considering the elimination of the luxury tax totally to stimulate sales, employment and government revenues. The unhappy experiment has come full cycle in Britain.

We have our own recent experience in the United States with the volatility of the boating marketplace. In 1980, President Carter's Administration proposed a standby weekend boating ban as a "symbolic energy conservation measure." Although the measure was only proposed, and withdrawn less than one-hundred eighty days later, sales were stopped dead in the water. Forty percent of our sales and fifty thousand jobs were lost in the industry in those six months. Many businesses went bankrupt, bank loans were unpaid and tax revenues from our industry went way down. In a lot of ways we were victims of our own government.

NMMA believes the Congress acted correctly in 1965 when it eliminated virtually all then existing excise taxes. The legislative history is quite clear that the Congress believed excise taxes, enacted as emergency measures during war time and depression, were a drag on the economy and discriminated among products. The imposition of excise taxes now on recreational boating would ignore the lessons learned twenty years ago.

As noted earlier, our industry is quite diverse. Of the 1,800 boatmakers in the United States, the substantial majority employ fewer than 100 employees. The same pattern holds for accessories manufacturers and those in related services. The dealers of our products, who also would bear the burden of lost sales, are also small businesses. We are largely an industry of small businesses. Many boat makers occupy market niches with a single product; others produce full lines while others specialize in a line of boats. All these manufacturers have vastly different cost, profit, pricing and sales configurations. A 10% tax would create distortions among firms. There would be no horizontal equity among competitors as a result of the tax. Some firms could absorb more of the tax in their pricing structure. Other firms with less flexibility would be squeezed out of a previously successful market. The discriminatory nature of the tax is clear as the smaller manufacturers in our industry would likely be hit the hardest. Purchasers would likely postpone purchases of all boats, not merely those with the highest effective ad valorem rate. While a manufacturer with a full line of boats would certainly be better positioned to handle "step down" buyers at the expense of a specialized maker, the likely scenario is that the purchasor, faced with a "less for more" choice, would simply withdraw from the market and move to competing, alternative, untaxed, recreation choices.

The fact is that more revenues can be obtained from the boating industry if government assists the industry's sales rather than penalizes the industry and its customers with excise taxes. An example of such assistance would include the elimination of excessive tariffs on our products by Canada. We have sought, through the current bilateral negotiations with Canada, to eliminate or substantially reduce the Canadian tariffs on our product. Those tariffs are seven to nine times our own modest duties. As a result of the Canadian duties, we have an

avorable trade balance with Canada. We urge your support of United States Trade Representative in his efforts to conclude ch an agreement including tariff elimination by both countries . our products.

We have been persistent in our efforts in recent years to achieve total elimination of these duties by both Canada and the United States. If the negotiations fail in this objective, we urge the Committee to act on H.R. 2602 the Small Business Bilateral Free Trade Act of 1987, a bill which would achieve tariff parity on our products by raising our duties to a level equal to Canadia tariffs. A similar bill has been introduced in the Senate.

Over recent years the industry has lost hundreds of millions of dollars in sales abroad as a result of such tariffs. The strength of the dollar did play a part in our exporting difficulties. But as willing and able as our manufacturers are to compete internationally, we cannot both compensate for the strong dollar and high tariff inequalities. Without such tariff inequalities our sales would likely increase and would generate additional tax revenues this Committee seeks.

A similar discriminatory economic effect on boating manufacturers and customers would result from the proposed elimination of the qualified residence interest deduction for boats. Not only is the proposal unfair, according to Joint Committee estimates the elimination will raise very little revenue, less than $50 million. The motivation for this proposal again appears to be based on a misperception of who owns boats. As explained below, the proposed elimination not only discriminates among recreation housing choices, but hits the often less expensive alternative the hardest.

How many real estate second homes are there? In states like Florida, Colorado, Texas and California, not to mention Wisconsin, Michigan and Minnesota, there are clearly tens of thousands. Probably most are located on or near the beach, a lake or in the mountains where people either retire or enjoy recreation at their second home. Many are quite modest indeed and some are very luxurious and large; most fall in between. Their numbers are clearly in the millions and, within these millions, a minority are mobile second homes such as motorhomes and boats.

We know that boats as second homes compete with other types of second homes. In general, a boat which has the live aboard features required to be a second home is cheaper than purchasing real estate and erecting a structure for the same second home purpose. You can't get much of a cabin on a wooded lot, in the mountains, or on the beach for $15,000 or $20,000 or even $50,000 but 75% of all live aboard boats can be purchased for $50,000 or less. The boat as a second home is very much a middle-class phenomenon. It is for many families the affordable alternative to second homes that involve real estate.

With the philosophical commitment to progressivity in our tax code, it would be highly inequitable--not to mention unpopular--to take away the interest deduction for the less expensive second home choice of the middle-class along without eliminating it for all of second homes. (And, if the interest deduction for all second homes is eliminated, their sheer number would suggest a widespread negative economic impact.)

Over the past three days the Committee has heard testimony both opposing certain revenue raising options and suggesting alternatives. It is our own view that the fairest tax is a broad based tax. Broad based taxes not only cause fewer distortions, but produce more revenue. We would support individual income tax increases as an example of a broad based revenue raising measure or a broad based energy tax.

In conclusion Mr. Chairman, we are opposed to excise taxes generally and we object strenuously to those proposed taxes aimed at one industry, our industry, alone. Boating is at the moment a growing business again in the United States. It is popular with many people, but primarily, our studies show, among working, middle class families. They are the backbone of our growth. The Joint Committee proposals would penalize those small businesses, cause disruption in the industry, depress sales, and ultimately lose revenue for the government. We urge the Committee to reject this harmful and discriminatory tax proposal.

Mr. GUARINI. Thank you, Mr. Napier. Mr. Richard C. Notebaert, Cellular Telecommunications Industry Association. Did I pronounce that correctly, sir?

STATEMENT OF RICHARD C. NOTEBAERT, MEMBER, BOARD OF DIRECTORS, CELLULAR TELECOMMUNICATIONS INDUSTRY ASSOCIATION, AND PRESIDENT, AMERITECH MOBILE COMMUNICATIONS, INC.

Mr. NOTEBAERT. Yes, my name is Richard Notebaert, and I am the president of Ameritech Mobile Communications, based in Schaumburg, IL.

I would like to thank the committee for the opportunity to testify here today. The views expressed are those of Ameritech Mobile and on behalf of the members of the Cellular Telecommunications Industry Association, the CTIA. CTIA is the trade association for the cellular industry, representing nearly 85 percent of all cellular carriers, both wireline and nonwireline, in addition to nearly all major manufacturers involved with cellular.

CTIA estimates that by the end of 1987 there may well be more than 1 million subscribers. There are presently more than 200 systems operating in 124 cities.

The purpose of my testimony is to ask that you oppose an option before you to increase the Federal excise tax on cellular mobile telephone service from its current level of 3 to 5 percent.

Cellular mobile telephones are not luxury items for the rich. The vast majority of cellular customers are small business people who drive pickup trucks, delivery vans, cars, station wagons, and domestic four-door sedans. Cellular is a tool to increase productivity and efficiency, and is an important communications facility for police, fire, medical, and other similar public safety bodies. It should not be arbitrarily singled out for increased taxation.

Cellular mobile telephone service is still in its infancy. The proposed Federal excise tax increase on cellular would generate only a small amount of revenue for the Government, and could give the wrong signals to our prospective and existing customer base.

Cellular investment is over $1.5 billion with thousands of American investors betting the ranch that cellular will continue to grow. During cellular's 4 short years, the trend of declining prices and increasing affordability has been a key to our growth. Discriminatory taxation could stunt our infant industry's development and diminish its ability to continue new manufacturing and service sector employment growth.

Cellular mobile telephones are tools, not luxury items. Ameritech Mobile Communications inaugurated the Nation's first commercial system in Chicago on October 13, 1983. In those early days cellular phones cost the owner $3,000 installed. Today, only 4 years later, equipment is $1,000 installed. Typical cellular users are small businessmen, commission sales people, and other self-employed individuals, as well as public safety bodies, such as fire, police, medical, and municipal officials.

Most importantly, some customers are telling us they couldn't operate without their car phone. In addition to regularly scheduled market research, our employees call 400 to 600 customers per

month as part of a customer care program. Virtually all customers consider cellular a solid productivity tool, based on those calls.

It is an important aid to the efficiency and competitiveness of the mainstream and highly mobile American business community.

Supporting that fact, according to a March 1987 survey, 98 percent of cellular user respondents indicated that they use cellular in a business context. Cellular is a small business person's tool. In the 4 years since Ameritech Mobile first started cellular in Chicago, the median cellular user's personal income has dropped 31 percent, and the typical customer owns or works for an enterprise employing fewer than 15 people. In fact, the cellular industry would starve if it relied solely on owners of premium-priced automobiles.

As word of mouth spreads and prices continue to move downward, cellular will extend its benefits of increased productivity to an even wider range of customers. In the future, for example, we will see cellular technology give service to homes and businesses in rural and remote areas of the nation on a fixed basis where it is inefficient to provide wire or uneconomical to install, also because of terrain problems.

A tax increase from 3 to 5 percent would generate only nominal incremental revenues for the Government. Ameritech Mobile services over 70,000 customers and remitted $1.2 million in Federal excise tax. Nationwide the industry paid approximately $12 million in excise taxes. Congress certainly can appreciate the risk-reward relationship of imposing an additional 2-percent tax on an infant industry like cellular. Uncle Sam would get another $800,000 from Ameritech Mobile and Ameritech Mobile's existing and prospective customers would get the wrong signal. A Federal excise tax increase would do harm because cellular has been singled out. Customers' natural expectations and reactions would be to expect further taxes; cellular sales would be slowed at best.

A key point is that cellular can contribute more ultimately to the tax coffers by increased cellular availability to the public. Businesses use cellular to increase productivity and margins and thus pay taxes on those increased revenues and profits.

New systems are being added weekly. Two hundred systems nationwide are valued over $1.5 billion. Most of these systems will not see a break-even for years, and investors understandably get nervous when their high-technology industry is targeted for unfavorable tax treatment. And this will cause a slowdown in the employment and revenue growth for affected equipment manufacturers and system operators.

Clear signals are important. Increasing the Federal excise tax from 3 to 5 percent may not flash a red signal to completely stop cellular growth, but certainly it will slow growth. The signal the committee needs to send is green: no additional taxes and full speed ahead for the development of cellular and mobile communications.

Thank you.

[The statement of Mr. Notebaert follows:]

TESTIMONY

My name is Richard C. Notebaert and I am President of Ameritech Mobile Communications, Inc., 1515 Woodfield Rd., Schaumburg, Illinois 60173.

I would like to thank the Committee on Ways and Means for this opportunity to testify here today. The views expressed are those of Ameritech Mobile and on behalf of the members of the Cellular Telecommunications Industry Association (CTIA). CTIA is the trade association for the cellular industry, representing nearly 85 percent of all cellular carriers, both wireline and non-wireline, in addition to nearly all major manufacturers involved with cellular. Ameritech serves on the CTIA Board of Directors.

CTIA reported that there were 680,000 cellular subscribers at the end of 1986 and estimates that by the end of 1987 there may well be more than a million subscribers. There are presently more than 200 systems operating in 124 cities.

The purpose of my testimony is to ask that you oppose an option before you to increase the Federal Excise Tax on cellular mobile telephone service from its current level of 3% to 5%.

In support of the Cellular industry's opposition to the increase, I will demonstrate the following:

- Cellular mobile telephones are not "luxury items for the rich" - the vast majority of cellular customers are small-business people who drive pick-up trucks, delivery vans, cabs, station wagons, and domestic four-door sedans. Cellular is a tool to increase productivity and efficiency, not a toy, and is an important communications facility for police, fire, medical and other similar public safety bodies. It should not be arbitrarily singled out for increased taxation.

- Cellular mobile telephone service is still in its infancy. The proposed Federal Excise Tax increase on cellular would generate only a small amount of revenue for the government - and could give the wrong "signals" to our prospective (and existing) customers by imposing additional costs of doing business on the predominantly small entrepreneurs who utilize the service.

- Cellular investment is over $1.5 billion dollars with thousands of American investors "betting the ranch" that cellular will continue to grow. During cellular's four short years the trend of declining prices and increasing affordability has been a key to growth. Discriminatory taxation could stunt our infant industry's development and diminish its ability to continue new manufacturing and service sector employment growth.

CELLULAR MOBILE TELEPHONES ARE TOOLS NOT LUXURY ITEMS

Ameritech Mobile Communications, Inc. inaugurated the nation's first commercial system in Chicago on October 13, 1983. To be sure, there were a fair share of Mercedes, BMW's and Cadillac limousines with pigtail cellular antennas those first weeks. In those early days, cellular phones cost the owner $3,000 installed. Today, only four years later the "street price" for comparable, or even better, equipment is about $1,000, installed.

I might add that not all cellular mobile service relies on automobiles - a small, but growing percentage of our business originates from hand-held portables and transportables that inhabit everything from briefcases to tool boxes.

In early 1984, less than 6% of Ameritech's customers had cellular installed in trucks or vans. Three years later, in early 1987, truck/van installation had zoomed to 21%. Another growing user category is public safety bodies - fire, police, medical institutions, municipal officials, utilities personnel and so on.

Obviously, we cannot keep tabs on all styles and models of cellular vehicles, but we can track age of vehicle for installation warranty work: from a high of 48%, new car installations represent only 13% of Ameritech Mobile's new installs today. All this only serves to demonstrate that the typical cellular users are small businessmen, commission sales persons or other self-employed individuals.

Most importantly, customers are telling us how they use cellular to increase their productivity - some going so far as to say they "couldn't operate without their car phone". In addition to regularly scheduled market research, our employees call 400 - 600 customers per month as a part of a Customer Care program. The feedback from those calls confirms the fact that virtually all customers consider cellular a solid productivity tool - not a toy. It is an important aid to the efficiency and competitiveness of the mainstream and highly mobile American business community.

Supporting that fact, according to a March 1987 survey, 98% of cellular user respondents indicated that they use cellular in a business context.

One final bit of information supports the concept of cellular as a small business person's tool rather than a luxury item: in the four years since Ameritech Mobile first started cellular in Chicago, the median cellular users' personal income has dropped 31%. And the typical customer owns or works for an enterprise employing fewer than 15 persons. The fact is the cellular industry would starve if it relied solely on owners of premium priced automobiles. As word of mouth spreads, and prices continue to move downward, cellular will extend its benefits of increased productivity to an even wider range of customers. In the future, for example, we will see cellular technology give service to homes and businesses in rural and remote areas of the nation on a "fixed" basis where it is now too expensive to run copper lines or not feasible to install them because of the terrain.

A TAX INCREASE FROM 3% TO 5% WOULD GENERATE ONLY NOMINAL INCREMENTAL REVENUES FOR THE GOVERNMENT

Ameritech Mobile serves over 70,000 cellular customers in five Midwestern states. In 1986, Ameritech Mobile remitted $1.2 million in Federal Excise Tax. Nationwide, in 1986, the industry paid approximately $12 million in excise taxes. Congress certainly can appreciate the risk/reward relationship of imposing an additional 2% tax on an infant industry like cellular. Uncle Sam would get another $800,000 from Ameritech Mobile, and Ameritech Mobile's existing and prospective customers would get the wrong "signal". For four years, the cost of cellular has gone down. A Federal Excise Tax increase could do harm because cellular has been "singled-out". Customers' natural reactions will be to expect further (luxury) taxes, etc. - cellular sales may be slowed at best. Obviously, a 2% tax increase would not be expected to improve cellular sales penetration.

A key point is that cellular can contribute more, ultimately, to the tax coffers by increased cellular availability to the public, i.e., businesses use cellular to increase productivity and margins and thus pay taxes on those increased revenues and profits.

Cellular investors may also get the wrong signals if cellular is singled out for a 2% excise tax increase. Literally thousands of investors and users have a stake in the 200+ cellular systems in operation today. New systems are being added weekly - increasing the national investment base to over $1.5 billion dollars. Most of these systems will not see a "break-even" for years, and investors understandably get nervous when their high-technology industry is targeted for unfavorable tax treatment. And this will cause a slowdown in the employment and revenue growth for affected equipment manufacturers and system operators.

CLEAR SIGNALS ARE NEEDED

"Clear signals" are important to this four-year-old American industry that needs a strong flow of new customers for its continued health, growth and return on investment. Increasing the Federal Excise Tax from 3% to 5% may not flash a "red" signal to completely stop cellular's growth but certainly will result in a "yellow" or caution signal that could slow growth. The tax signal the Committee needs to display is "green", i.e., no additional taxes and full speed ahead for the development of cellular mobile communications. Clear signals will insure that more cellular customers will be able to take advantage of increased productivity and efficiency, lowered costs and higher margins. This in turn will earn more taxable revenues from the cellular customers, cellular investors and employees of the cellular industry. And certainly our national goals of increased productivity, competitiveness, and a favorable balance of trade will be served.

Thank you for the opportunity to appear on behalf of Ameritech Mobile and the cellular industry. I would be pleased to answer any questions you may have.

Mr. GUARINI. Thank you very much, sir. Mr. Bennet Miller, president of the Tri-County Telephone Co. on behalf of the United States Telephone Association. We welcome you, sir.

STATEMENT OF BENNET R. MILLER, PRESIDENT, TRI-COUNTY TELEPHONE CO., NEW RICHMOND, IN, AND CHAIRMAN, UNITED STATES TELEPHONE ASSOCIATION

Mr. MILLER. Thank you, Mr. Chairman. My name is Bennet R. Miller, and I am the president of the Tri-County Telephone Co. in New Richmond, IN, and chairman of the United States Telephone Association. The USTA represents more than 1,100 local telephone companies, ranging in size from the 7 new regional Bell companies to companies serving fewer than 30 homes. The USTA membership provides roughly 99 percent of the local telephone service in the United States.

Mr. Chairman, in July of 1986 I came before this committee to testify against the proposed extension of the telephone excise tax as a revenue measure.

One year later I am returning to testify not only against the proposed extension of the telephone excise tax, but also proposals to increase the tax, repeal its exemptions, tax the sale of telephone equipment, and increase the tax on cellular and mobile services.

I would like to bring to this committee's attention a Washington Post-ABC News poll published July 2 that reported the public's view of various proposed taxes. The highest disapproval rating of all was for raising taxes on telephone service. Eighty-seven percent of Americans polled rejected them, while, by comparison 74 percent opposed personal income tax increases. Opposition to all other taxes was far lower.

USTA opposes the extension and increase of the telephone excise tax for several very important reasons that are detailed in my written testimony.

The telephone excise tax fails to meet any of the three criteria for a legitimate excise tax set forth by Assistant Secretary of the Treasury Roger Mentz last year. Those criteria are external social costs, user fees, and nondistortive consumption taxes.

Also, the telephone excise tax is regressive and the only tax on a basic service. There is no tax, as you know, on water, electric, or gas.

Although a number of exemptions from this tax create administrative burdens for telephone companies, repeal of the exemptions from the communications excise tax is unjustified for the same reasons that we oppose the imposition of the tax on our customers in the first place. An improper tax does not warrant new targets. Moreover, each exemption was placed in the code for a specific reason.

Clearly, there is little justification for continuing, expanding, or increasing the telephone excise tax. Congress has been trying to eliminate it since 1959. It should do so now.

Further, the Joint Committee on Taxation has proposed a 10 percent tax on the sale of telephone equipment. This simply will not work. In an era when the distinctions between computers and communications equipment are becoming blurred, it would be almost

impossible to determine which equipment should be subject to a communications excise sales tax. First, the same equipment can be purchased for communications and noncommunications purposes. Second, much of this equipment purchased today provides both taxable and nontaxable services simultaneously. Moreover, the imposition of a one-time 10-percent sales tax is not comparable to an ongoing 3-percent tax on communications service. This tax would be difficult, if not impossible, to administer in a fashion that ensures parity among today's untaxed bypassers and taxed local telephone customers.

The staff proposal recommending a higher rate of tax for cellular and other mobile services use is unwarranted. It represents a discrimination between various technological means of providing telecommunications services, it would chill the technological development of these promising services, and it would discriminate against people in rural areas along with others who depend greatly on these services.

This technology's future is extremely bright. It holds great potential for rural telephone customers. That is why the Federal Communications Commission has encouraged the use of mobile radio technology in high-cost areas. To that end, a number of telephone companies are conducting trials of digital radio phone technology as a practical means of bringing telephone service to rural areas where installation of conventional cable is prohibitively expensive because of distance, difficult terrain, or low population density. What may be erroneously perceived as a luxury item is actually the new hope for clear, affordable, state-of-the-art service for rural customers.

Finally, little revenue would be generated from a differential tax on mobile service. The percentage of mobile traffic is low when compared to the telephone traffic generally.

Mr. Chairman, I believe that our customers do not deserve to be singled out for a discriminatory tax on a basic service. The telephone excise tax should be permitted to expire at the end of the year as scheduled, and taxation of sales of communications equipment and the increased taxation of cellular mobile services should be rejected. Eighty-seven percent of Americans polled seem to agree.

Thank you very much for allowing us, our association, to appear before this committee.

[The statement of Mr. Miller follows:]

Written Statement
of
Bennet R. Miller
President of Tri-County Telephone Company
New Richmond, Indiana
on behalf of the
United States Telephone Association

Thank you Mr. Chairman, my name is Bennet R. Miller, and I am President of the Tri-County Telephone Company in New Richmond, Indiana, and Chairman of the United States Telephone Association. USTA represents more than 1100 local telephone companies ranging in size from the seven new regional telephone companies to companies serving less than thirty homes. USTA member companies provide roughly 99 percent of the local telephone service in the United States.

I would like to state for the record that local telephone companies do pay taxes and have, in fact, relatively high effective tax rates.

Mr. Chairman, in July of 1986, I came before this Committee to testify against the proposed extension of the telephone excise tax as a revenue raising source.

One year later, I find myself back before this Committee to testify not only against the proposed extension of the telephone excise tax but also against a proposed increase in the telephone excise tax, a proposed repeal of the exemptions from the telephone excise tax, a proposed tax on the sale of telephone equipment, and a proposed tax on cellular and mobile telecommunications services.

RECENT POLL INDICATES CONSUMERS MOST STRONGLY OPPOSE TAXES ON TELEPHONE SERVICE

I worry greatly that some in Congress may incorrectly perceive that regulated local telephone companies and their customers are an easy source for general revenue raising, and that taxes imposed on local telephone customers go unnoticed. To correct this misperception I would like to bring to this Committee's attention a Washington Post-ABC News Poll published July 2 (see attached) that demonstrates that more Americans disapprove of further taxation of telephone service than disapprove of any other proposed tax. Eighty-seven percent of Americans polled--seven out of eight--disapproved of increased taxation of telephone use. This 87 percent disapproval is even greater than the 74 percent who disapproved of raising personal income taxes and far outdistanced all other proposed taxes.

Telephone customers do not want to be singled out for discriminatory treatment, and I believe that the following testimony may be helpful to the Committee in understanding why this is the case.

THE EXTENSION AND INCREASE OF THE TELEPHONE EXCISE TAX

USTA opposes the extension and increase of the telephone excise tax for three very important reasons:

First of all, the telephone excise tax fails to meet any of the three criteria for a legitimate excise tax set forth by Assistant Secretary of the Treasury Roger Mentz in his testimony last year before the Senate Finance Committee.

Second, the telephone excise tax encourages bypass, creating upward pressure on residential rates.

Third, the telephone excise tax is regressive and is a tax on a basic service.

Treasury Criteria Not Met

In a statement before the Senate Finance Committee on April 21, 1986, Mr. J. Roger Mentz, the Assistant Secretary of the Treasury for Tax Policy set forth the three circumstances under which the imposition of an excise tax may be justified:

The first Treasury criteria which justifies imposition of an excise tax is External Social Cost, where the tax represents a

reimbursement to society of the external costs associated with the product or service taxed. There is no external social cost associated with telephone service.

The second criteria is the User Fee scenario under which the excise tax functions as a user fee when the federal government provides services that benefit the user of the product or service taxed. This is obviously not the case with the telephone excise tax.

Finally, with Nondistortive Consumption taxes, an excise tax is imposed on a service or product that is unresponsive to price changes. Price is very important to telephone customers in today's competitive environment.

Clearly, the telephone excise tax does not fit the Treasury's criteria for a legitimate excise tax.

Bypass Encouraged by the Tax

The major competitive problem with the telephone excise tax is that it encourages bypass. While customers of regulated utilities are subject to the tax, those who bypass the local network are not. In fact, application of a tax on bypass facilities would be very difficult to administer and would require a different application than is used for regulated industry. As will be explained later, the proposed tax on the sale of telephone equipment would not solve this problem.

The Tax is Regressive

Further, the telephone excise tax is particulary unfair to consumers in that:

1. The tax is regressive because it falls more heavily on lower income groups;
2. The tax is imposed on a necessity used by most homes and businesses;
3. Among the four basic household utilities--electricity, gas, water and telephone--only telephone service is subject to federal excise tax.

Clearly, there is little justification for continuing, expanding or increasing a tax that:

1. fails to meet the Treasury criteria for a legitimate excise tax;
2. encourages bypass;
3. is inherently regressive and unfair to ratepayers; and
4. is nothing like other excise taxes on luxury products and services.

The telephone excise tax, which Congress has been trying to eliminate since 1959, should not be extended.

THE REPEAL OF EXEMPTIONS FROM THE TELEPHONE EXCISE TAX

The Joint Committee on Taxation's description of revenue options includes a proposal to repeal the current exemptions from the communications excise tax. Among services not subjected to the tax are private communications services; certain coin operated service; news services; international, etc. organizations; servicemen in combat zone; items otherwise taxed; common carriers and communications companies; installation charges, non-profit hospitals; state and local governments; and non-profit educational organizations.

Although a number of exemptions from this tax create administrative burdens for telephone companies, repeal of these exemptions from the communications excise tax is unjustified for the same reasons that we oppose the imposition of the tax on our customers in the first place. An improper tax does not warrant

new targets. Moreover, each of these exemptions was placed in the Code for a specific reason after great deliberation by this body. Those sound reasons for the exemptions have not changed.

One example of this body's concise rationale is the reasoning behind the exemption for private communications services. The exemption for private communications services was placed in the Code in 1965. This Committee's Report (H. Rpt. 89-433) cited the following rationale for making this exemption:

> Under present law, a private communications system such as a private line or a private intercommunication system set up for a single subscriber (such as a PBX system or Centrex service) is taxed as a part of general telephone service if the telephones in this system have access to the local exchange system.
>
> This has presented problems under present law because of competition from untaxed private equipment performing similar services. The telephone companies presently are losing intrapremise business (and interpremise business within local areas) to those providing telephone and microwave equipment which can be purchased and operated by the users themselves. Installation of equipment in this manner is accompanied by a reduction in the service from the local telephone company. Businesses installing their own internal communications systems in this manner avoid the tax on the telephone company's charge for both equipment and services. With the ever-increasing number of varied services which modern science makes it possible for telephone companies to provide, the tax on private communication systems represents a severe competitive handicap to the expanded use of these new and varied services.

Technology and the competitive nature of the marketplace have changed dramatically since this exemption was placed in the law, making the importance of its goal--parity among providers of telecommunications services--more critical than ever.

Despite the policy and consumer objections to its imposition, the telephone excise tax continues to be considered as source of revenue for the Treasury. The tax continued in great part because consumers did not organize to oppose it. The attached Washington Post-ABC News Poll suggests that consumer reaction may not be so indifferent going forward.

TAXATION OF TELEPHONE EQUIPMENT SALES

The Joint Committee on Taxation's revenue options include, "...a 10 percent excise tax... imposed on all telephone equipment (including fiber optic links) and communications satellites sold to persons for use in a manner not subject to the telephone excise tax." While there may be merit in instituting public policy measures to discourage bypass of the public telephone network, imposing a sales tax on telephone equipment cannot be considered a comparable tax to the telephone excise tax.

The problem of comparability is two-fold. In an era when the distinctions between computers and communications equipment are becoming blurred, it would be almost impossible to determine which equipment should be subject to a communications equipment sales tax. First, the same equipment can be purchased for communications and non-communications purposes. Second, much of the communications equipment purchased today is used to provide both "taxable" and "non-taxable" services simultaneously. Moreover, the imposition of a one-time ten-percent sales tax cannot be considered comparable to the imposition of an ongoing three-percent tax on communications service. Clearly, this tax

would be difficult if not impossible to impose in a fashion which ensures parity among today's untaxed bypassers and taxed local telephone customers.

TAXATION OF CELLULAR AND MOBILE SERVICES

The staff proposal recommending a higher rate of tax for cellular and other mobile telephone usage is unwarranted. It represents a discrimination between various technological means of providing telecommunications services, it would chill the technological development of these promising services, and it discriminates against people in rural areas along with others who depend greatly on these services.

This technology's future is extremely bright, its potential enormous. We have found that digital radio frequencies are more secure than analog radio systems or other wireless systems, that voice and data are easily handled on the same circuit, and that there is clear, high-quality transmission with little or no noise. The cost of these services compares favorably with alternative technologies, and these systems can transmit data, an advantage for customers with computers. To single out this new service with a differential tax would have a dramatic, chilling effect on the development of what is a relatively new technology.

Furthermore, to differentiate among technological means of providing telephone service has no rational basis, particularly since the cellular and other radio technologies are utilized in providing much more than mobile service. There is great potential for rural telephone customers. That is why the Federal Communications Commission has encouraged the use of mobile radio technology in high-cost areas where a radio link is less expensive than providing service through traditional copper wire. To that end, a number of telephone companies are conducting trials of digital radio phone technology as a practical means of bringing telephone service to rural areas where installation of conventional cable is prohibitively expensive because of distance, difficult terrain, or low population density. The advantage of mobile service for rural residential customers is a reduction in the cost of providing conventional service. In other words, what may be erroneously perceived as a luxury item is actually the new hope for clear, affordable, state-of-the-art service for rural telephone customers.

Taxing mobile services at a higher level than traditional wire-based services would be unfair to those who must use the technology either for basic service or because their occupation requires them to be on the move. This would come at a time when costs of the service are now starting to decline, thus making the service more affordable.

Finally, little revenue would be generated from a differential tax on mobile service. The percentage of mobile traffic is low when compared with telephone traffic generally, perhaps one or two percent.

CONCLUSION

Mr. Chairman, taxation of the use of the telephone is not a good idea. As evidence by the Washington Post/ABC News Poll, it is very unpopular with the American people. Telephone service is a basic service, not a luxury item. The telephone excise tax fails to meet any of the Treasury's criteria for a legitimate excise tax and the proposals to tax equipment sales along with cellular and mobile service would skew competition and chill technological development. Consideration of such taxes could not come at a worse time as local telephone companies struggle to maintain reasonable rates in the face of increasing costs and intense challenges from unregulated competitors.

Confidence in Reagan on Deficit Declines

Poll Finds Greater Trust in Congressional Democrats to Handle Red-Ink Problem

WASHINGTON POST-ABC NEWS POLL

Q. At this point, who do you trust to do a better job in reducing the federal budget deficit—Reagan or the Democrats in Congress?

Reagan	40%
Democrats	50
Neither	7
Other/No opinion	3

Q. Who would you say is more to blame for the large deficit, Reagan or the Democrats?

Reagan	46
Democrats	41
Both equally	9
No opinion	4

Q. I am going to mention some things that have been proposed to help balance the federal budget, and for each, please tell me whether you approve or disapprove of that proposal:

	APPROVE	DISAPPROVE	NO OPINION
A. Raising taxes on gasoline	27%	73%	0%
B. Raising taxes on liquor, beer, cigarettes	75	25	0
C. Raising taxes for telephone use	13	87	0
D. Raising taxes on airline tickets	42	57	1
E. Raising taxes on business corporations	67	32	1
F. Raising taxes on higher-income people	71	28	1
G. Raising income taxes for everybody	25	74	1

Figures are from a Washington Post-ABC News telephone poll of 1,506 people June 25 to June 29.

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Mr. GUARINI. Thank you very much, Mr. Miller.

Mr. Fredric Ziegler, director of financial analysis, Texas Statewide Telephone Cooperative, on behalf of the National Telephone Cooperative Association.

Mr. Ziegler, welcome.

STATEMENT OF FREDRIC J. ZIEGLER, DIRECTOR OF FINANCIAL ANALYSIS, TEXAS STATEWIDE TELEPHONE COOPERATIVE, INC., ON BEHALF OF THE NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Mr. ZIEGLER. Mr. Chairman and members of the committee, my name is Fredric J. Ziegler. I am representing the Texas Statewide Telephone Cooperative, Inc., a telephone industry organization dedicated to representing and serving the interests of the Texas rural independent telephone systems. TSTCI represents 35 telephone companies located in the vast rural and agricultural areas of Texas. The overall density of most of the TSTCI companies' service area ranges from a low of approximately 0.6 customers per mile of telephone line up to only five customers per mile of telephone line. I am testifying today on behalf of the National Telephone Cooperative Association, a national trade association representing 450 rural telephone cooperatives and locally owned commercial telephone companies.

Mr. Chairman, with your permission, I will read a summary of my comments today, but ask that my full statement be inserted into the record.

Mr. GUARINI. Right. Thank you very much. It will.

Mr. ZIEGLER. The joint committee's option to increase or extend the telephone excise tax is unfair for several reasons. The telephone excise tax is the only excise tax imposed upon a household utility. There is no such tax levied on electricity, gas or water. Unlike other utilities, consumers of telephone service are experiencing an increase in their telephone bills in piecemeal fashion.

For instance, the Federal Communications Commission recently increased the subscriber line charge to $3.50 a month. In addition, many State and local governments have imposed their own tax on telephone service. 911 surcharges are also added to monthly bills in many States.

Because of the cumulative effect of these State and Federal charges, telephone subscribers are already bearing a substantial tax burden. Residents of the areas which we serve are finding it more difficult to afford the necessity of telephone service in light of the depressed economic situation facing our Nation's rural areas. Any further increase in the cost of providing telephone service creates an undue economic hardship for the rural residents and jeopardizes our Nation's goal of providing universal telephone service.

The telephone excise tax is contrary to the Federal excise tax system in that it is not a sumptuary or luxury tax, nor are its receipts used to provide a benefit related to communications service.

The Federal excise tax on telephone service is a tax on a necessity. The importance of telephone service is quite clear to the subscribers of the cooperatives in Texas where the density is very low. Access to telephone service to call a doctor, the sheriff or the fire

department in an emergency situation is especially essential in such sparsely populated rural areas.

Another important factor to consider is the regressive nature of the tax. The impact of the Federal excise tax on telephone service is greatest on low and middle income households. The great proportion of telephone subscribers in rural areas are from lower and middle income families.

In 1984 the per-capita income of rural residents was only 75 percent of that of urban residents, $10,092 compared to $13,603. The regressive nature of the tax is further amplified by the fact that rural residents rely on toll service for daily living and business use. Rural residents must make more toll calls than their urban counterpart.

For instance, it is likely that a call to a country doctor will be a toll call. With consolidated schools in the rural areas, it is also likely that a call to the child's school will be a toll call. It is even more likely that the farm equipment retailer will be located in a different local exchange area than most of its customers.

The committee raised the possibility of increasing the excise tax on cellular and mobile telephone services. The Federal Communications Commission is proceeding at a fast track to establish licensing rules for rural cellular service. However, one of the disadvantages rural telephone companies face is the prohibitive expense of providing cellular service.

An increase in the communications excise tax would further increase the cost burden rural communications customers encounter and would hinder rural residents from access to cellular technology that is readily available in the urban areas.

The committee also suggested a 10-percent sales tax on equipment purchased by persons for use in a manner not subject to telephone excise in an attempt to prevent the escape of the excise tax by bypassers. The committee's recognition of this problem is appreciated. However, identifying the customer who had used the equipment in a manner not subject to the Federal excise tax would be virtually impossible. As a result, the flat 10-percent excise tax would be imposed on all telecommunications equipment to all.

We encourage the committee to further research ways to impose this excise tax on bypassers. Our association would be glad to assist in this endeavor.

The NTCA respectfully requests that the committee consider the points we have raised today and proceed in a manner consistent with the historic objective of Congress to eliminate the tax on communications services.

We appreciate and recognize the importance of reducing our Nation's Federal deficit. Because of this, we realize that it is unrealistic and perhaps inappropriate to ask that the Federal excise tax on telephone service expire at the end of this year. However, we do recommend that if the committee decides that the excise tax must be extended for another year, a mechanism be included that would allow for the ultimate phaseout of the excise tax. We support the Joint Committee option to extend the telephone excise tax at 3 percent for 1 year, with subsequent reduction in the rate by 0.5 percentage points per year.

Mr. Chairman, this concludes my prepared statement. I am happy to answer any questions you or Members of the committee may have.

[The statement of Mr. Ziegler follows:]

TESTIMONY OF

FREDRIC J. ZIEGLER

ON BEHALF OF THE

NATIONAL TELEPHONE COOPERATIVE ASSOCIATION

Chairman Rostenkowski, Members of the Committee, my name is Fredric J. Ziegler. I am representing the Texas Statewide Telephone Cooperative, Inc., a telephone industry organization dedicated to representing and serving the interests of the Texas rural independent telephone systems. TSTCI represents 35 telephone companies located in the vast rural and agricultural areas of Texas. The overall density of most of the TSTCI companies' service area ranges from a low of approximately .6 customers per mile of telephone line up to only 5 customers per mile of telephone line. I am testifying today on behalf of the National Telephone Cooperative Association (NTCA), a national trade association representing over 450 small telephone systems serving rural consumers in over 40 states.

The Joint Committee on Taxation suggests a number of options to raise revenue which relates to the telephone excise tax. Among them are: extend the existing tax of 3% for 3 years; extend the 3% rate for 3 years and increase to 5% for cellular and mobile telephone usage; increase the telephone excise tax to 4% for 3 years; extend the 3% rate for one year and phase it out by 0.5 percentage points per year; repeal the present exemptions for the telephone excise tax; or impose a 10% excise tax on telephone equipment sold to persons for use in a manner not subject to the telephone excise tax.

Today I would like to describe why an excise tax is inequitable in today's deregulated telecommunications environment.

Current Law and History of Telephone Excise Tax

The federal excise tax on telephone services applies to general telephone service and toll service. Repeal of the telephone excise tax is scheduled to occur at the end of this year.

Over the last two decades there have been numerous attempts by Congress to phase down and ultimately repeal this tax. However, revenue problems have arisen before the total repeal of the tax was allowed to occur. In each instance, Congress either increased the rate or postponed the repeal date.

The fact that Congress recognizes the unfair characteristics of the telephone excise tax is illustrated in the Senate Finance Committee Report on the Excise Tax Reduction Act of 1965:

> ...the tax on local and toll telephone service and the teletypewriters exchange service is undesirable as a permanent feature of our excise tax system. This conclusion was reached on the grounds, first, that these taxes are regressive and therefore fall with greater severity on those with low incomes than those with higher incomes. Second, the charges for telephone services enter heavily into business costs. Therefore, the tax discriminates against those firms that must make extensive use of the taxed services (Senate Report No. 89-324, Excise Tax Reduction Act of 1965, June 14, 1965, pp. 34-35).

Impact of an Increase or Extension of the Communications Excise Tax

The Joint Committee on Taxation's option to increase or extend the telephone excise tax is unfair for the following reasons:

The telephone excise tax is contrary to federal excise tax policy. Other excise taxes can be categorized in the following groups: sumptuary taxes, luxury taxes, or excise taxes dedicated to trust funds. The telephone excise tax does not fit any of these categories.

A sumptuary tax is imposed on items which exact a social toll on society. The imposition of such a tax is used to help discourage the use of such products. Examples are the excise tax on cigarettes and alcohol. Telephone service is a necessity and should not be categorized as a sumptuary tax.

Other excise taxes are designed to be imposed on what many believe are luxuries. Such taxes are commonly used for revenue raising purposes and the impact of a tax is intended to be on higher income individuals. This follows our nation's philosophy that our tax system should be progressive in that those with the greatest ability to pay are taxed at a greater rate than that of low income individuals. The federal excise tax on telephone service is a tax on a necessity. The importance of telephone service is quite clear to the subscribers of

my telephone company in Texas where there are between 0.6 and 5 customers per mile of telephone line. The need to have access to telephone service to call a doctor, sheriff, or fire department in an emergency situation is especially essential in such sparsely populated rural areas.

The other category of excise tax is where the excise tax is levied on certain products or services and the revenues raised by such a tax are used to provide the resources for a related benefit. For instance, the tax on gasoline or other fuels is placed in a fund used to build and maintain highways.The excise tax on telephone services does not go into a special fund to provide lifeline service to low income customers. Instead, it is treated as general receipts of the U. S. Treasury.

It is clear that the current law telephone excise tax does not fit into any of the aforementioned categories.

The telephone excise is the only excise tax imposed on a household utility. There is no such tax levied on electricity, gas, or water. To subject telephone telephone service to federal excise taxation is inconsistent in this respect also.

Unlike the other utilities, consumers of telephone service are experiencing an increase in their telephone bills in piecemeal fashion. For instance, the Federal Communications Commission (FCC) recently increased the subscriber line charge to $3.50 per month. In addition, many state and local governments have imposed their own tax on telephone service. 911 surcharges are also added to monthly bills in many states.

Because of the cumulative effect of these state and federal charges, telephone subscribers are already bearing a substantial tax burden. Residents of the areas which we serve are finding it more difficult to afford the necessity of telephone service in light of the depressed economic situation facing our nation's rural areas. Any further increase in the cost of providing telephone service creates an undue economic hardship for rural residents and jeopardizes our nation's goal of providing universal telephone service.

Another important factor to consider is the regressive nature of the tax. The impact of the federal excise tax on telephone service is greatest on low and middle income households. A great proportion of telephone subscribers in rural areas are from lower - and middle-income families. The per capita income of rural residents in 1984 was only 75% of that of urban residents - $10,092 compared to $13,603.

The regressive nature of the tax is further exacerbated by the fact that rural residents rely on toll service for daily living and business use. Rural residents make more toll calls than their urban counterpart. For instance, it is likely that a call to a country doctor will be a toll call. With consolidated schools in the rural areas, it is also likely that a call to a child's school will be a toll call. It is even more likely that a farm equipment retailer is located in a different local exchange area than most of its customers.

Increasing the Excise Tax on Cellular and Mobile Telephone Services

The Federal Communications Commission (FCC) is proceeding on a fast track to establish licensing rules for rural cellular service. However, one of the disadvantages rural telephone companies face is the prohibitive expense of providing cellular service. An increase in the communications excise tax would further increase the cost burden rural communications customers encounter and would hinder rural residents from access to cellular technology that is readily available in urban areas.

Excise Tax on Sale of Telecommunications Equipment by Customers who would use the equipment in a manner not subject to the federal excise tax

The Committee suggests a 10% excise tax on equipment purchased by persons for use in a manner not subject to the telephone excise tax in an attempt to prevent the escape of the excise tax by bypassers.

In light of deregulation and technological advancement, private businesses can purchase their own telephone equipment and by-pass the local exchange provider. Local exchange companies are required to collect the federal excise tax, but the non-regulated bypassers are not. The private bypasser can offer a lower cost of service because its customers are not subject to the telephone

excise tax. Demand for telephone service by businesses users responds to price changes because they are able to bypass telephone networks when ownership of their own telephone system is feasible. This creates an economic hardship for the local exchange provider because their important business customers can move to other networks which then reduces the efficiency of the local exchange network.

The Committee's recognition of this problem is appreciated. However, identifying the customer who would use the total equipment in a manner not subject to the federal telephone excise tax would be virtually impossible. As a result, the flat 10 percent excise tax would be imposed on all telecommunications equipment to all consumers. This would further increase the cost imposed on the consumer and add a further undue tax burden on the telephone customer.

We encourage the committee to further research ways to impose the excise tax on bypassers. Our association would be glad to assist in this endeavor.

Summary

The telephone excise tax is unfair to telephone companies and subscribers because:

- It is contrary to the federal excise tax system in that it is not a sumptuary or luxury tax, nor are its receipts used to provide a benefit related to communications service;
- The tax is levied on a necessity used by most homes and businesses;
- The telephone customer is currently bearing a substantial tax burden on telephone service. The FCC recently increased the subscriber line charge to $3.50 per month, state and local governments have imposed their own tax on telephone service; 911 surcharges are added to monthly bills;
- Telephone customers of NTCA members live in sparsely populated economically depressed rural areas. Any further increase in monthly telephone bills would create undue economic hardship;
- The telephone excise tax is regressive. The impact of the tax is greatest on low-and middle-income households and on rural customers who must make more toll calls than urban residents;
- Rural areas are exploring the viability of entering the cellular market. An increase in the excise tax on cellular and mobile communications would further hinder the ability of rural service areas to have access to cellular telecommunications of the same quality as urban areas.
- It is doubtful that an excise tax on communications equipment would solve the bypass problem because of the difficulty in identifying bypassers. The administrability of the option is nebulous.

NTCA respectfully requests that the Committee consider the points we have raised today and proceed in a manner consistent with the historic objective of Congress to eliminate the tax on communications services.

We appreciate and recognize the importance of reducing our nation's federal deficit. Because of this, we realize that it is unrealistic and perhaps inappropriate to ask that the federal excise tax on telephone service expire at the end of this year. However, we do recommend that if the committee decides that the excise tax must be extended for another year, a mechanism be included that would allow for the ultimate phase out of the excise tax. We support the Joint Committee option to extend the telephone excise tax at 3% for one year, with subsequent reduction in the rate by 0.5 percentage points per year.

APPENDIX A

Current Law and History of the Federal Excise Tax on Communications Services

There has been a federal excise tax imposed on communications services since 1914 - with the exception of periods from 1916 to 1917 and 1924 to 1932. Until the enactment of the Revenue Act of 1941, the tax was levied on telephone toll, telegraph, radio message charges and leased wire services. Local telephone service was added as a taxable service in 1941.

During World War II, the communications excise rates were at their highest - 25 percent on toll messages and leased wire services, 15 percent on local service, and 8 percent on wire and equipment services. These rates were initially scheduled to be reduced six months after the hostilities ended. However, they were continued until 1954, when the rates on local, toll and leased wire services were reduced to 10 percent.

Tax Rate Extension Act of 1959 provided that the tax on general telephone service would expire in 1960. This was the first attempt to eliminate the communications excise tax, but like many of the attempts that followed, the proposal was repealed before it went into effect.

In 1965, the Excise Tax Reduction Act called for the sunset of the tax over the years 1965-1969. The rate reductions were repealed by the Tax Adjustment Act of 1966 but provisions were made for the reduction of the 10% rate to 1% effective April 1, 1968 and elimination of the tax on January 1, 1969.

The Revenue Expenditures Control Act of 1968 altered the proposed elimination and continued the 10% rate and established a schedule for elimination of the tax from 1970 to 1973. The Tax Reform Act of 1969 extended the effective dates by one year.

In 1970, the Excise, Estate, and Gift Tax Adjustment Act extended the 10% rate through 1972 and set a phase out schedule of a one percent reduction per year with termination in 1982.

The one percent reductions occurred from 1973 to 1980. The Omnibus Reconciliation Act of 1980 extended the termination by one year and a 2 percent excise tax rate was maintained for 1980 and 1981. In 1981, the Economic Recovery Tax Act extended the expiration date through 1984.

The 1982 Tax Act raised the tax from 2% to 3% and provided for continuation of the tax through 1985. The 1984 Deficit Reduction Act extended the 3% rate through the end of this year.

Mr. GUARINI. Thank you very much, Mr. Ziegler. Have you found that when we impose a 3-percent excise tax that there is any difference in your business or in your profit picture or the amount of telephone usage that has occurred?

Mr. ZIEGLER. No, sir, that is not the case. Telephone usage is a necessity today, so therefore, if a call is going to be made, it is going to be made whether there is an excise tax there or not.

Mr. GUARINI. So that you haven't been hurt in any way whatsoever, but it does give less room when you apply for rate increases, is that part of the picture?

Mr. ZIEGLER. Well, it doesn't hurt from the standpoint that the call is not being made. The concern, and where the problem lies, is that the total cost of that call is increasing; therefore, the calls will still be made; so, therefore, the money has to be taken from other areas of a person's budget in order to make that call. He has to have the telephone service.

Mr. GUARINI. Since the deregulation, your telephone area has done better than it ever has before, as far as business is concerned, is that a fair statement?

Mr. ZIEGLER. Well, that would be a fair statement when you consider the aspect of access charges, which are the charges that are applicable to the inner exchange carriers which they pay the local exchange carriers for access to the local customer.

Mr. GUARINI. Mr. Leeds, when we repealed the luxury tax on jewelry in 1965, we had a 20-year experience base on that type of a tax. Could you tell us, from your viewpoint, how successful a tax that was?

Mr. LEEDS. Well, we had a decline in employment in our industry because of that tax, and a decline of sales.

Mr. GUARINI. Well, there is a tax on beer; there is no tax on someone who buys a gold ring or a piece of jewelry. Is it fair—and we are talking about fairness as being the basis for tax compliance—is it fair to have no tax on a piece of jewelry you'd buy at Tiffany's yet a tax on a glass of beer that a man wants to buy when he goes to a baseball game?

Mr. LEEDS. Well, most of the jewelry is not purchased in Tiffany's, of course; it's purchased——

Mr. GUARINI. Well, let's say it's purchased in any neighboring store in America.

Mr. LEEDS. Well, we are already suffering in our industry, we have a very depressed situation—we are not doing well as it is. Any further tax on our jewelry sales would just be, in our opinion, disastrous to compete in the market place.

Mr. GUARINI. Well, if you agree that we should narrow our budget deficit, and if we do need to raise some taxes that would be dedicated to the budget shortfall, what kind of a tax would you suggest would be a fair tax?

Mr. LEEDS. I'll defer this statement to Mr. Runci next to me.

Mr. RUNCI. Sir, we have given this matter some consideration and have two suggestions for you. The first would be consideration of a possible Federal tax amnesty. This would encourage back taxes to be paid, and presumably bringing in an immediate influx of revenue; and, secondly, with more strict enforcement, may indeed bring more taxpayers back onto the tax rolls. We would urge that

tax experts within the staff of this committee address that as one possibility.

But more broadly speaking, sir, we would suggest that our product may indeed be taxable and should be taxed if the intent to tax is broad-based, if it is not discriminatory and selective.

In response partially to the question you just asked Mr. Leeds, we believe that our testimony and the documentation we would be happy to provide in further detail to the committee adequately demonstrates that jewelry indeed is not a luxury item insofar as the demographics of consumer purchases in this country today go.

Mr. GUARINI. Well, some of them are luxury; it depends on the cost. I assume that across America there are less expensive items that the average public can afford and does use.

Mr. RUNCI. Yes, sir.

Mr. GUARINI. You do have the full spectrum.

Mr. RUNCI. Yes, sir, we do.

Mr. GUARINI. Would you be in favor of a surtax on income tax as a lesser alternative?

Mr. RUNCI. We are not here to comment, sir, on the matter of other alternatives to the committee before the committee in its consideration. We recognize and acknowledge and respect the problem that faces you, but we would like to confine our remarks really to the area of possible excise taxes, and simply say that, assuming that the committee has addressed and considered the question of spending and spending reductions to its satisfaction, and assuming further that the matter of income taxes have been addressed and that that has been rejected, and that then the alternative before the committee is excise taxes, that we would propose those taxes be across the board and fairly distributed among all products rather than selective and arbitrary and applying only to some.

Mr. GUARINI. And be progressive?

Mr. RUNCI. Yes.

Mr. GUARINI. Mr. Napier, you said that there was a study that had taken place concerning what would happen to the boat industry and would show a loss of business if the taxes were increased.

Have you got a copy of that study that we could put in the record?

Mr. NAPIER. Mr. Chairman, we in the industry, that is to say, individual companies do what amounts to a proprietary elasticity study to determine how much they can increase their prices, and they do that to determine what types of investment they can make in new product, in new plants, and so forth, and how they can recapture those costs. The studies that have been made available to me are proprietary studies. There is other information which I can make available to the committee on the same subject, and will do so.

Mr. GUARINI. If you have any objective, acceptable business analysis or study——

Mr. NAPIER. I think we do, yes, sir.

Mr. GUARINI [continuing]. We would appreciate it if you could put it into the record so we can all benefit from it.

Mr. NAPIER. We will do that with the nonproprietary data.

Mr. GUARINI. Thank you. Mr. Crane?

Mr. CRANE. Thank you, Mr. Chairman, and I welcome the panel before us, and especially two constituents in Mr. Napier and Mr. Notebaert. I appreciate your testimony, gentlemen, and, frankly, take a dim view of this whole exercise we are going through. If you hearken back to 1984—was that when you were here, Mr. Miller, to testify, when we were considering deficit reduction taxes in 1984?

Mr. MILLER. I was not here in 1984.

Mr. CRANE. The reason I mentioned that was we extended the telephone tax until the end of this year as a means of guaranteeing that we were going to reduce the deficit, and you saw how successful that effort was.

The Joint Committee on Taxation has this proposal, you know, with the hike in the percent charged for telephone usage with a discriminatory variable against cellular and mobile telephone usage. And then they go on, under their possible proposals, and they say after a 1-year extension, at the present rate the telephone tax could be phased out by half a percentage point per year, looking to the future. I opposed these taxes to begin with, and I argued at the time that once put in place, I don't care whether they have termination dates, they never terminate. They simply extend—and, in this case, they are proposing increases, and discriminatory increases at that. I couldn't agree with you more, that the telephone is an absolute necessity in a home.

What percentage of homes have telephones in America now?

Mr. MILLER. We probably have the highest percentage now that we have ever had. I think it's running around 93 percent.

Mr. CRANE. That's what I had heard, that it was in the 90-percent range—and I guess that's the highest of anywhere in the world, isn't it?

Mr. MILLER. Yes.

Mr. CRANE. How telephones got singled out for this specialized kind of treatment in the first place, in contrast, as you noted in your testimony, to other utilities—electricity and water and so forth—is a little hard to comprehend. Mr. Napier knows my district well, and I can guarantee you, as far as I am concerned, we are not going to do it to the people up on the Chain of Lakes. I have about 10 interconnected lakes, Mr. Chairman, in my district, and they have about 50,000 power boats up on those lakes every weekend. And I didn't realize we were down so low: Illinois is only 11th in boat ownership. I would have guessed we were higher.

But I noted that my colleague to my left here, Mr. Frenzel, his State of Minnesota, with a much smaller population base, is No. 2 in the Nation.

So I think you've got some support on this committee, and especially when you invoke the British experience and how it devastated the industry over there. As in so many of our misguided actions, when we levy taxes we don't always anticipate what the consequences will be, because we don't run this place like a business and so we don't have to worry about profit and loss here. That's what has created the dilemma.

I reflect back on 1982 when we passed the Tax Equity and Fiscal Responsibility Act, what the President was promised at that time was a $3 reduction in spending for every dollar increase in taxes

that he signed off on. And I told him at the time that I felt it was a mistake to sign off on taxes until he had the spending reductions in hand, and, sure enough, what we got for every dollar increase in taxes was a $1.47 increase in spending, which is typical of the actions by the Congress of the United States, sad to say. And I don't anticipate that any effort at increasing taxes this year to address deficits is going to accomplish the objective, and, based upon all past experience, the more we raise, the more we spend.

So I intend to fight aggressively to prevent any tax increases of any sort and simultaneously to work to get spending reductions.

But let me ask Mr. Notebaert a question. The implication, I gather, about cellular and mobile usage telephones is that only the rich are using these devices and that that is the rationale behind the differential in the taxes that would be imposed on that particular model. Is that what the thinking is behind this?

Mr. NOTEBAERT. Well, that was the perception and originally, when we started our system, the median income of those individuals was high. In the last 3 to 4 years it's come way down, and it has become a productivity tool and a method to gain efficiency in the business.

Mr. CRANE. Well, that makes a lot of sense certainly, and, frankly, I don't think if you had had differentials like that, that treated the technology on a different basis than the existing technology, you would have seen the productivity increases and decline in the cost of service and expansion of a very valuable service to more people.

Well, I commend you all. And on the question of beer versus jewelry, let me just inject one thing. The fact of the matter is that excise taxes are regressive and have always been regressive taxes. But with regard to jewelry purchases, as the father of seven daughters, I can guarantee you it's not the very rich that are buying most of the jewelry. And to attempt to suggest that there are people such as myself, who do like beer now and then, I still resent that hidden tax on the beer when I can afford the beer more than my daughters can afford the jewelry. So I would hope that we wouldn't single out the jewelry industry, Frank.

Mr. GUARINI. Maybe the Chair should entertain a motion to reduce the tax on beer.

Mr. CRANE. Oh, I'm all for that; I would eliminate it altogether.

Mr. GUARINI. That would be very popular.

Mr. CRANE. Well, the fact of the matter is, excise taxes are the most iniquitous kinds of taxes that can be levied. They are hidden taxes, they are regressive taxes invariably. If we are going to tax people, we should be upfront about it: let everybody know exactly how much he is paying, you know, to carry this establishment down here. And for that reason I would hope that we might engage in some more serious pursuit later by this committee, and that is review the entire Tax Code. Last year's effort certainly was no shining example.

I thank you all for your testimony

Mr. GUARINI. I'd like to join my colleague in agreeing with the fact that excise taxes are regressive, they do target industries and regions, they do displace employment. And when we try to have a fair Tax Code, what we are really doing is going in the wrong direc-

tion and creating a nonfair basis by hitting the very people that we try to help the most.

Mr. CRANE. I'd like to add to that that they are discriminatory, because, you know, it's certain industries that get targeted. For example, do sailboats get taxed, get hit with an excise tax? Do you know, Mr. Napier?

Mr. NAPIER. Under this proposal, Congressman, they would, yes.

Mr. CRANE. How about snowmobiles?

Mr. NAPIER. Snowmobiles would not, as I understand. I haven't read the proposals other than those that are applicable to our industry, so I can't say that for sure.

Mr. CRANE. Because, you know, you can run down a list of items like that, and why some should be singled out and others not is, again, one more illustration of the unfairness of that kind of a tax.

Thank you.

Mr. GUARINI. There's another item, too, that's seldom spoken about, and that is the inflationary factor, because when you have an excise tax, the cost of a product is not just the sum of that extra tax, but there is also additional monies that are piled onto the cost of the product, which is profit. So, therefore, it causes more than the cost of the tax when the product comes to retail.

So it does have an inflationary trend.

Mr. CRANE. Well, you are absolutely correct, and I commend the panel before us today for their testimony.

Thank you.

Mr. GUARINI. Mr. Frenzel?

Mr. FRENZEL. Thank you, Mr. Chairman. I thank the panel for its splendid testimony. Mr. Chairman, I know you wouldn't have asked questions about luxury taxes on jewelry if you had known Mr. Leeds was from my district; you would have been much nicer to him. [Laughter.]

Mr. Leeds—and may I say to Mr. Ziegler, you are certainly well represented today; you have hired able staff to keep you going.

Mr. ZIEGLER. Thank you, sir.

Mr. FRENZEL. Mr. Leeds, you are a manufacturer.

Mr. LEEDS. Yes, sir.

Mr. FRENZEL. Not a retailer.

Mr. LEEDS. A manufacturer. We employ 700 people.

Mr. FRENZEL. And you don't manufacture on the higher price range of jewelry, do you?

Mr. LEEDS. About 85 percent is in the lower price range.

Mr. FRENZEL. Sort of the kind of thing that Mr. Crane's daughters would buy?

Mr. LEEDS. Yes, the affordable products for graduation, confirmation, Mother's Day, Father's Day.

Mr. FRENZEL. And so judged against the need to eat they may be a luxury product, but judged against the usual American consumption patterns, you are not manufacturing luxury products except at the high end of your range.

Mr. LEEDS. That's correct.

Mr. FRENZEL. And so to tax your product and call it a luxury tax is misleading advertising?

Mr. LEEDS. Very, very misleading.

Mr. FRENZEL. I believe that's true, too. Can you tell me if, when we passed our free trade agreement with Israel, were you one of those companies affected by gold chain imports and other——

Mr. LEEDS. No, sir, I don't deal in gold chain.

Mr. FRENZEL. You don't. Can your friend tell me if the industry was affected?

Mr. RUNCI. Yes, sir, the industry has been affected; indeed, the industry opposed the——

Mr. FRENZEL. I remember it vividly.

Mr. RUNCI. The particular segment of the industry to which you refer, gold chain manufacturing, has been in decline for quite a period, not only or primarily as a result of that particular situation; rather more, earlier in time, as a result of the tremendous imports of gold chain primarily from Italy. But that particular segment was already depressed at the time that that action occurred.

Mr. FRENZEL. Well, if we could name all the states California, we could have the business boom again, I suppose. [Laughter.]

Can you tell me, Mr. Leeds, how imports affect your business?

Mr. LEEDS. Well, right now approximately 35 percent of my business is lost to imports.

Mr. FRENZEL. And you indicate in your testimony that 10 years ago, how much less, 10 percent of the domestic market for imports?

Mr. RUNCI. About 5 to 8 percent, sir. I believe it's about 33 percent industrywide today.

Mr. FRENZEL. And is that figure still growing?

Mr. RUNCI. Yes, it is, annually.

Mr. FRENZEL. On the other hand, however, sales of those products would also be taxed under the excise tax proposals, so there is not specifically an advantage or disadvantage there, or do I misread it?

Mr. RUNCI. Well, we would observe, sir, that there may be a tendency for large-volume purchasers to source more merchandise offshore by virtue of the price differential that manufacturing bases, particularly in southeast Asia, currently enjoy as against domestic manufacturers.

So while both products, the domestic product and the imported product, would be taxed identically under this proposal, nonetheless we feel that more business might be lost to offshore producers as a result of the ability to make up some of that difference at retail by buying a cheaper product overseas.

So there may indeed be an incentive nonetheless.

Mr. FRENZEL. Thank you, that's an interesting point I hadn't considered. Mr. Chairman, I think the panel has done a good job on excise taxes, as have the others during the day, and I am particularly glad that you restrained your testimony to the business that concerns you. Every person that comes here is asked by the chairman—not this one, whoever is chairman—well, don't you think we have to raise taxes? And all of you are smart enough to respond that that isn't what you came to testify about; you came to testify about kinds of taxes which may be imposed on your business. And that is something on which you are qualified to render expert testimony. The business of raising taxes at all is of great concern to me. I believe we should have cut expenditures rather than raising taxes and that to come in now and say, well, our budget is set and there-

fore we have to raise taxes is simply avoiding difficult choices which have to be made eventually, and which should be made right now. And I don't think that we have to consider your recommendations in the terms of whatever budget we are working under now. We ought to consider them in the terms that they are made, and I think that they were well made.

Mr. Chairman, I yield the balance of my time.

Mr. GUARINI. Mr. Pease?

Mr. PEASE. I have no questions, Mr. Chairman.

Mr. GUARINI. I want to give you a special thanks for your help, your testimony, and for being patient during the day. And with this we will adjourn the meeting. The hearing will continue on Wednesday, July 15, beginning at 10 a.m. in this room, 1100 Longworth House Office Building. The testimony will begin with Members of Congress at that time.

Thank you very much, gentlemen.

[Whereupon, at 3:31 p.m., the committee adjourned, to reconvene at 10 a.m., Wednesday, July 15, 1987.]

87-665 (880)